3D ADVISORS

This 3DAdvisors Report Covers:	
	Insider Trading: Insider Trading Behavior
✓	**Accounting**: Quality of Earnings Issues
	Governance: Corporate Governance Issues
✓	**Fundamentals:** Analysis of fundamentals

Weakening Economy and Competition Increase Risks Apollo Group Inc. (NASDAQ:APOL) Update

October 15, 2008

Contact: Bob Gabele (954) 779-3974 or bgabele@3DAdvisors.com

Business Description

Apollo Group Inc., through its subsidiaries, provides various educational programs and services at high school, college, and graduate levels. Its subsidiaries include University of Phoenix, Inc. (UPX), Institute for Professional Development, Inc. (IPD), The College for Financial Planning Institutes Corporation (CFP), Western International University, Inc. (WIU), and Insight Schools, Inc. (Insight). As of August 31, 2007, the company offered its educational programs and services at 102 campuses and 157 learning centers in 40 states and the District of Columbia; Puerto Rico; Alberta and British Columbia; Canada; Mexico; and the Netherlands. The Company was founded in 1973 and is headquartered in Phoenix, Arizona.

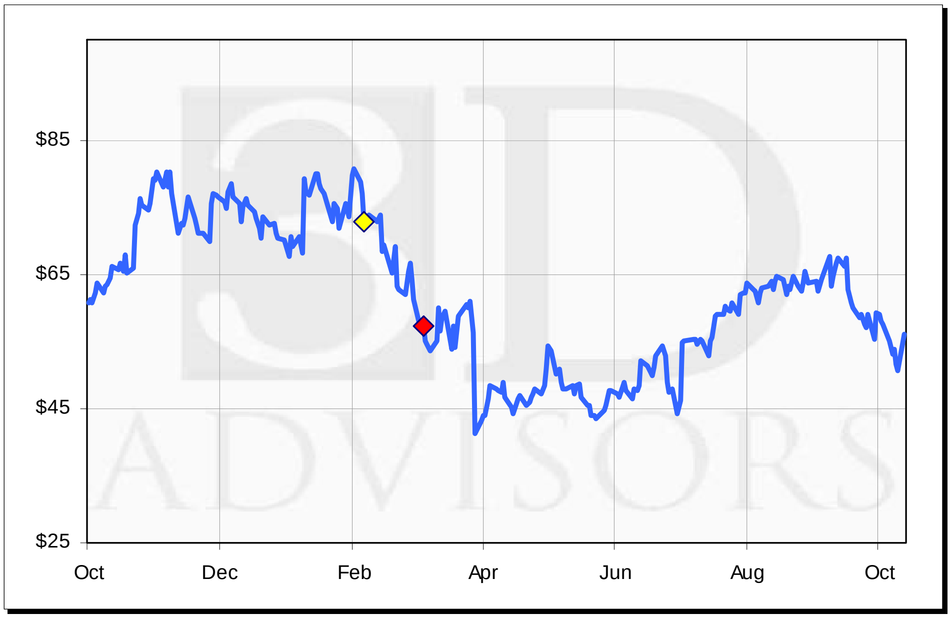
Summary of 3DAdvisors Findings for APOL

- **Accounting:** Despite obfuscations, quality of receivables likely to decline further
- **Fundamentals:** Reliance on associate degree programs adds to risks
- **Fundamentals:** Exec turnover muddles leadership while increasing competition
- **Fundamentals:** Other evidence that competition may be heating up
- **Other:** Miscellaneous noteworthy items

Discussion of 3DAdvisors Findings for APOL

After the gains made by Apollo Group Inc. (APOL) shares in recent months, the Company is back on our radar because one of the central themes at the time of our full report back on 03/04/08 was that the Company was increasingly reliant on students in its associate degree programs who are much more at risk as consumer credit tightens and the economy slows. Back in March, the shares were trading in the $57 range just prior to the 35% slide precipitated by the Company's March 27th Q2 earnings release. The quarter revealed increasing costs associated with enrollment counselor turnover, increasing advertising expense, shifting geographical marketing strategies and a dramatic change in the Company's refund policy, all telltale signs of increasing competition on top of the risks associated with the weakening economy.

Figure 1. APOL Daily Closing Price, 10/01/07 through 10/13/08. Yellow diamond is the date of the *Insider Research Bulletin* (02/06/08) featuring the aggressive trading profile of APOL insiders; Red diamond is the date of the full report (03/04/08). Source: Reuters and 3DAdvisors, LLC.



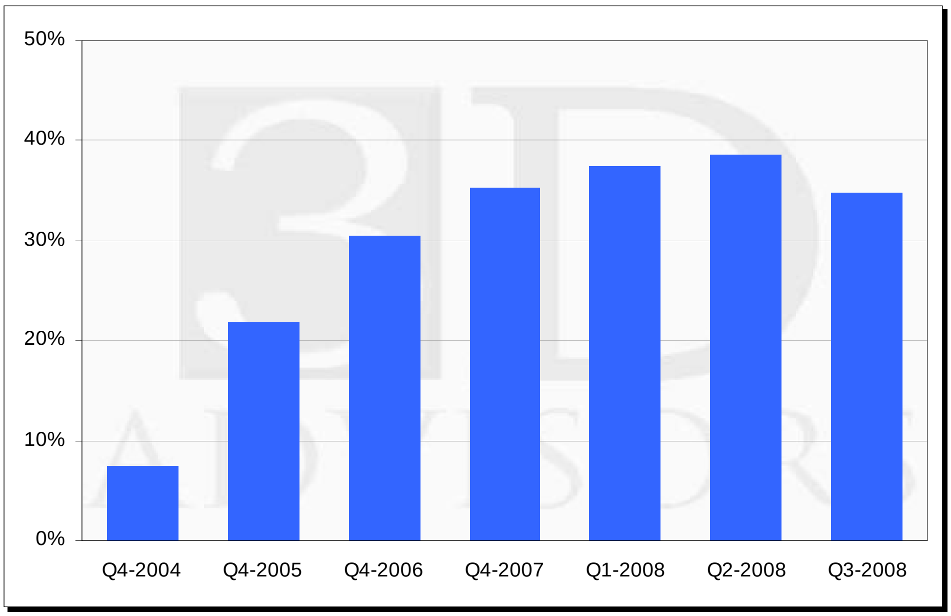
Since the dip down to a 52-week low of $37.93 shortly after the 2Q08 earnings, the stock had rallied back up above $65 partially in response to a favorable court ruling reversing a class-action suit which had caused the Company to record a $170 million charge and post a $95 million bond for potential damages. Aside from this possible plus, which would only become reality should there be no appeal, there seems little else to account for the resilience shown by APOL shares during this past summer and up until the hit taken over the past couple of weeks during the market meltdown. But as the financial crisis that has weighed on most stocks threatens to significantly worsen the economic outlook for consumers in the near-term, combined with continuing evidence of increasing competition in the for-profit education market and a long history of suspect accounting, governance and trading behaviors, APOL is a name we continue to monitor very closely with a high degree of interest.

<u>Accounting: Despite obfuscations, quality of receivables likely to decline further</u>

The poor condition of Apollo's accounts receivable assets is obvious given the hefty allowance for bad debt that the Company is forced to maintain (details below), but surprisingly little is known about the underlying details. Not only does the Company fail to provide useful data, it regularly engages in other obfuscation related to accounts receivable assets. For example, management went to some lengths to hype a decrease in DSO's during the 3Q08 conference call as they fell to 26 days from 30 days in 2Q08 and 37 in 1Q08, and implied that collection efficiencies were the driver of the improvements rather than the $66 million in bad receivables that were written off in Q2 and Q3. The write-off gave Apollo the breathing room to lower its related bad accounts receivable allowance, taking it down $11.3 million in 2Q08 and another $8.1 million in

3Q08. This caused the bad debt allowance to drop from 38.5% of total receivables in Q2 to a still high 34.7% in Q3. Whether this implies a need to take the allowance back up in future periods depends on what happens with delinquent accounts, but it seems pretty clear which way things are likely to go given the current state of the economy.

Figure 2. APOL Allowance for Bad Debt as a Percentage of Total Accounts Receivable. The percentage was reduced in 3Q08 due to a $38 million write-off, rather than a true improvement in the bad debt situation. Source: APOL SEC Filings.



In fact, the Company regularly engages in considerable rhetoric in its SEC filings and conference calls regarding bad debt expense. The rhetoric includes reclassifications from bad debt expense to revenue deductions, percentage comparisons, refund policy changes and unexplained plans to develop more effective means to reduce bad debt expense. All the rhetoric aside, the reality is that management has not demonstrated any success in actually reducing bad debt expense. Receivables write-offs for the nine months ended 05/31/08, were $93.8 million following write-offs of $56.4 million for the nine months ended 05/31/07. That is the reality, stripped of rhetoric.

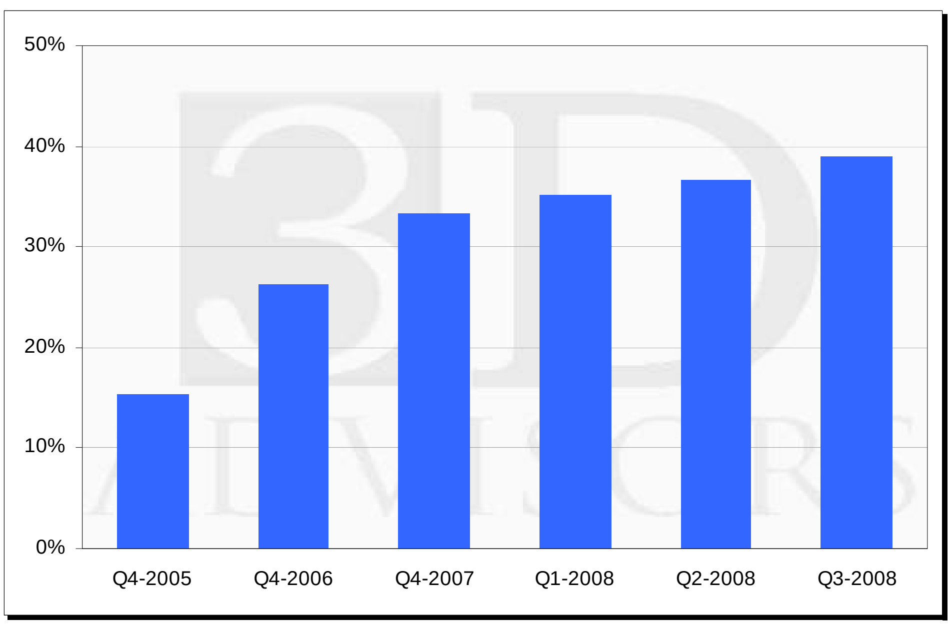
The lack of transparency and disclosure is becoming ever more troubling as the recent financial crisis spreads from Wall Street to Main Street and threatens to push the economy into a deeper and possibly more protracted recession. We wonder what the impact will be on the quality of these receivables, especially given the increased reliance on the lower quality associate degree programs (see below). But since the Company steadfastly refuses to provide any detail on the number of students in each program, revenue per student, default rates, or any other meaningful information, we are left to guess. For example, given the recent difficulties many consumers have had in obtaining credit, it would be useful to know what percentage of students rely on private loans to pay their tuition bills versus those that rely on federal loan programs, or employer tuition reimbursement, etc. The bottom line is that since we already know that the quality of receivables is poor and the Company provides so little information concerning the underlying details, the current economic environment and its attendant uncertainties add a considerable amount of risk to the outlook for APOL shares, in our opinion.

Fundamentals: Reliance on associate degree programs adds to risks

It is no secret that associate degree student revenue (Axia College) continues to be an increasing component of Apollo's total sales picture. Students in these programs are not only low in Apollo's hierarchy of creditworthiness but also represent lower margin customers than those enrolled in University of Phoenix's bachelor degree programs. Additionally, Axia College students are more prone to dropping out and defaulting on their loans. Despite this, the Company maintains that it expects a growing number of these students to go on to enroll in traditional bachelor degree programs but, true to form, no details on actual student transitions from the associate degree programs to the more profitable bachelor degree programs are offered.

In fact, as is well known in the analyst community and mentioned above, there is a surprising lack of disclosure and transparency when it comes to the number of students in each program, drop out rates, average revenue or any other meaningful metric that would allow an analyst to model with any degree of accuracy how the business actually works. What we do know, however, is that associate degree programs continue to grow as a percentage of total revenue, reaching 37% in the 3Q08, up from 29.9% for the same quarter a year ago.

Figure 3. Percentage of Total Revenue Derived from Associate Degree Programs. Source: APOL SEC Filings.



The obfuscation regarding key information in this key area is painfully obvious in each of the quarterly conference calls. During the 3Q08 conference call for instance, after having implied that bachelor degree starts had picked up, management was asked to quantify the progress, but as is typical, little supporting detail was offered:

> **Analyst:** Just a question on retention. Can you guys give any metric whatsoever that gauges that progress? And I'll ask the couple-quarter-old question about graduation and matriculation rates for Axia and especially in the context of the Bachelor starts sort of turning the corner. I guess, as part of the question, the question is, have they turned the corner, and should we see continued growth in Bachelor starts? I know that's multifaceted.
>
> **Joe D'Amico:** Yes. Let me take the last part first, on the associates graduates into the Bachelor program. That continues to go well. We continue to work on that, but we're very pleased with the progress that we've made today. Whether we've turned a corner -- I don't know that I can tell you that yet. We certainly, for the first time in several quarters, have had an increase in Bachelor starts. And we hope that that continues, but we can't give you any assurances on that.

Then, in a follow up question:

> **Analyst:** I just want to turn quickly back to Bachelor starts again and ask the question, with the month of June behind us, if you could comment on whether or not you saw continuation of the return in start growth in June on the Bachelor level. Thanks.
>
> **Joe D'Amico:** It's -- for Bachelors only, I don't have that information handy.
>
> **Analyst:** How about for the business, just overall -- starts for the overall business?
>
> **Greg Cappelli, EVP, Global Strategy:** We're just not going to comment on that.

<u>Fundamentals: Exec turnover muddles leadership while increasing competition</u>

Several high level defections by senior operating executives have fueled speculation not only about the internal climate at APOL that may be contributing to the bleeding but also about former APOL brass becoming competitors. There have been multiple resignations, all of them sudden and unexpected. The first was **Laura Palmer Noone** who had headed up the flagship University of Phoenix division until 2006 and recently has resurfaced as president of a new Apollo competitor, Phoenix-based Nouveau University. More recently, however, and more significantly, the recent sudden defection of University of Phoenix President and Director **Bill Mueller** turned out to be a bigger event than initially thought when he went over to another Arizona-based institution, Grand Canyon University, as it was later revealed that he took two key Apollo executives with him, **Stan Meyer** (Apollo's E.V.P. of Marketing and Enrollment) and **Dan Bachus** (Apollo's former Chief Accounting Officer). Meyer had also served on the board of Apollo's Axia College which offers the Associated Degrees that are becoming a driver of Apollo's revenue growth. The group departure for a single competitor, all hired on the same day, can only be looked on as a coup for Grand Canyon University which has filed its S-1 Registration Statement to go public (Grand Canyon Education, to be listed on NASDAQ under the symbol LOPE). The following disclosure from that S-1 says it all:

> Effective July 1, 2008, we hired Brian Mueller, Stan Meyer, and Dan Bachus to serve as our Chief Executive Officer, Executive Vice President, and Chief Financial Officer, respectively. Mr. Mueller has been involved in the education industry for over 25 years, most recently as the president of Apollo Group, Inc., a for-profit, postsecondary education company and the parent company of the University of Phoenix. Mr. Meyer, who also has over 25 years of experience in the education industry, most recently served as the executive vice president of marketing and enrollment for Apollo Group, Inc. Mr. Bachus, who is a certified public accountant, has worked in the education industry for approximately seven years, including as the chief accounting officer and controller for Apollo Group, Inc.

Another high level defection that we mentioned in our full report on 03/04/08 was that of Chief Administrative Officer **John Kline** to Nelnet Inc. (NYSE:NNI), a provider of education planning and financing to students, families, and schools in the United States. Kline, an Apollo named executive in the Company's 2006 SEC Form 10-K, had been with the Company prior to 1996 and had served three years (1996-1998) as Sr. V.P., Operations and Finance of UPX Online. We say "apparent defection" since Apollo did not disclose his departure, a disclosure that would normally be required and made in an SEC Form 8-K if he were still in fact a "named executive". Kline surfaced as a new officer (Executive Director) at NNI on 02/25/08 after he filed a Form 3 (Initial Statement of Beneficial Ownership of Securities) raising our antennae that he had, in fact, defected.

To this add the 2006 defection of Apollo CEO **Todd Nelson** to competitor Education Management Corp. His position had not been filled for 2 ½ years at the time of Mueller's departure. Industry scuttlebutt has it that Mueller's decision to leave became a fait accompli when he ultimately realized that he was not going to be offered the CEO position.

On a final note, we find it extremely interesting that for a Company this size none of the individuals above had employment agreements, and so they were able to leave Apollo and go directly to work for competitors, unencumbered by non-compete restrictions. This is not the first costly governance anomaly we have uncovered. In the full report in March we reported that the Company had changed the peer group it used in determining compensation for executives from a group of firms in the for-profit education market to a group of technology firms. The net result was a major, self-serving increase in executive compensation, especially equity-based compensation. It may turn out, however, that the failure to have in place non-competes for senior executives may be far more costly for shareholders in the long run.

<u>Fundamentals: Other evidence that competition may be heating up</u>

Evidence seems to suggest that competitive pressures continue to build, a fact that was not missed by analysts during the Company's 2Q08 conference call. The conference call revealed much about increasing expenses related to hiring new Enrollment Counselors which has raised Apollo's student acquisition costs by 17% sequentially (from $2,300 to $2,700 per student). Analysts drilling further into this were to find that a geographical shift has been occurring. Brian Mueller, the aforementioned and now departed head of the University of Phoenix stated during the call:

> With regards to the enrollment counselor there has been a steady change in the segmentation of our leads as we build more campuses in the Midwest, Southeast and Northeast, we are getting an increasing percentage of leads coming from those regions. That's shifting, causing us to want to shift the balance of our enrollment counselors out to those regions.

Mueller then went on to explain that the Company had hired 550 enrollment counselors in those regions. This suggests to us that increasing competition is costing Apollo market share in its traditional geographies, causing the Company to venture to new markets in its quest for growth.

When repeatedly asked about productivity metrics for counselors during the Q3 conference call Apollo management again retreats behind its veil of generalities, refusing to provide detail:

> **Analyst:** Going back to an earlier question about the enrollment counselors, you talked a little bit about turnover and about productivity. I wonder if you could give us a context for what was either productivity metrics that you'd like to use that you think are most accurate, compare that to where we were a year ago or compare to where you think you can get in the next year. And, probably as importantly, in terms of enrollment counselor turnover, especially the first six months of tenure, how much room do you think you have to improve that? And what kind of time frame should we think is the right time frame to improve that metric?
>
> **Joe D'Amico, Interim President, CFO, EVP, and Treasurer:** Well, we are not giving those measurements out. An enrollment counselor has an awfully difficult job. And so, we measure them on a number of factors, so I don't plan to give those measurements out. But I think we would say, though, just based on the growth in cost, what we would like to do is try to get it more in line with our growth in revenue. So that's the way we are looking at it. But we have a lot of measurements and statistics. Again, it's another area that's going to take a little bit of time to fix. There isn't a magic fix there, but we're going to look at some bigger ideas, if you will, to provide the support that we think will help them.

Perhaps the most telling clue that competitive pressures are mounting has been the shift in refund policies that became effective on 03/01/08. Prior to the change, when a University of Phoenix student attended their first class period, 25% of the total tuition was recognized. Once they attended two class periods, the full 100% of tuition would be recognized. Under the new revenue recognition policy, students who attend 60% or less of a course are eligible for a refund for the portion of the course they did not attend. This dramatic shift, which will almost certainly result in increased refunds, was altruistically explained by the Company as follows: "UPX [University of Phoenix] elected to change its refund policy because we believe it is a more reasonable policy from our students' perspective". We think it is more likely a response to competitive pressures.

Other: Miscellaneous noteworthy items

- There is still no renewal of the University of Phoenix certification under Title IV. The Company claims that there is no reason to believe that the renewal will not occur. The Company is reportedly still furnishing information to the DOE on the matter.

- Apollo Global (a joint venture with Carlyle Group set up to invest in or acquire overseas education businesses) has clearly not yet gotten off the ground. One wonders if the $199 million capital commitment from Carlyle will be forthcoming in the current environment.

- Now that the securities litigation judgment has been thrown out, interested parties should consider the likelihood of a reversal of the $166 million accrual, set up for that matter, in the 4Q08 and a reversal of the related deferred tax asset as well. That is if the plaintiffs decide not to appeal.

- With regard to Insight (high school diplomas), management states in Q2 that they were "very pleased" with its prospects and were approved in seven states, operating in four, with the prospect of being approved in 10 "by fall". They still do not reveal the number of students they have enrolled, or plan to enroll. The Company will be spending $12 million on Insight in 2009, about what they will lose in 2008.

- Management attributes the increase in selling and promotional expenses to the lack of effectiveness of enrollment counselors, but there is no apparent plan to address the problem other than by hiring more counselors due to high turnover.

- The turnover above helped contribute to contraction in margins. Revenue in 3Q08 increased 14%, yet pre-tax income rose by only 6%.

- The Company seems to take a rather liberal view as to likely outcome of pending litigation. In most cases no reserves have been recorded.

- Stock repurchases continue to make a large claim on available cash, while share based compensation continues to be a major expense item.