

# FINAL TRANSCRIPT

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## **APEI - Q2 2011 American Public Education Inc Earnings Conference Call**

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*American Public Education, Inc. - CEO, President*

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*Citigroup - Analyst*

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## PRESENTATION

**Operator**

Good day, ladies and gentlemen, and welcome to the second-quarter 2011 American Public Education Incorporated earnings conference call. My name is Jeff and I will be your operator for today. At this time, all participants are in a listen-only mode. Later, we will facilitate a question-and-answer session. (Operator Instructions). As a reminder, this conference is being recorded for replay purposes.

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I'd now like to turn the conference over to your host for today, Mr. Chris Symanoskie, Associate Vice President of Investor Relations. Please proceed, sir.

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**Chris Symanoskie** - American Public Education, Inc. - Director of IR

Thanks, Jeff. Good evening, and welcome to American Public Education's second-quarter 2011 earnings conference call. Presentation materials for today's call are available on the Webcast section of our Investor Relations website, and are included as an exhibit to our current report on Form 8-K filed earlier today. During the Q&A session, we ask that participants limit their questions to one question per caller to enable broader participation.

Please note that statements made in this conference call regarding American Public Education or its subsidiaries that are not historical facts are forward-looking statements based upon current expectations, assumptions, estimates and projections about American Public Education and the industry. These forward-looking statements are subject to risks and uncertainties that could cause actual future events or results to differ materially from such statements. Forward-looking statements can be identified by words such as anticipate, believe, could, estimate, expect, intend, may, should, will, and would. These forward-looking statements include, without limitation, statements about the third quarter 2011, as well as other statements regarding expected future growth.

Actual results could differ materially from those expressed or implied by these forward-looking statements, as a result of various factors, including the risk factors described in the Risk Factors section, or elsewhere in the Company's annual report on Form 10-K filed with the SEC, the Company's quarterly reports on Form 10-Q filed with the SEC, and the Company's other SEC filings. The Company undertakes no obligation to update publicly any forward-looking statements for any reason, even if new information becomes available or other events occur in the future.

This evening, it's my pleasure to introduce Dr. Wallace Boston, our President and CEO, and Harry Wilkins, our Executive Vice President and Chief Financial Officer. Now, at this time, I'll turn the call over to Dr. Boston.

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**Wallace Boston** - American Public Education, Inc. - CEO, President

Thank you, Chris. Beginning with Slide No. 3, the second quarter 2011 update, in today's conference call, I'd like to review the results of our operations for the second quarter of 2011 and highlight events that impact our success and underscore our continuing commitment to affordability and student success. Then Harry Wilkins, our Chief Financial Officer, will discuss our second-quarter financial results and provide additional perspective on our third-quarter outlook.

During the three months ended June 30, 2011 we continued to see strong interest from civilian students with a 96% increase over the prior year in net course registrations from students using Title IV. This growth was driven by a 150% increase over the prior year in net course registrations from new students using Title IV. Net course registrations from students using veterans' benefits increased 21% year over year. Moreover the growth of our military student population increased in line with our expectations as net course registrations from students using military tuition assistance, or TA, increased 9% year over year. Overall net course registrations increased 28% year over year with a 39% increase in net course registrations from new students. As of June 30, 2011 we have approximately 96,800 active students attending either AMU or APU.

While the military will always remain an important part of our institution's heritage, we plan to continue increasing the diversity of our student population with an emphasis on civilian outreach. Similar to our military outreach programs, we believe that our recent successes in civilian markets have been achieved through innovative awareness campaigns that focus on referrals, interactive media, and relationship building within the communities we serve.

Our message about the affordability and quality of our degree programs continues to resonate well within the civilian community. We believe APUS is increasingly becoming the university of choice for civilian students seeking affordable and effective online



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higher education. In addition to our broadening alumni referral base, our regional television and radio campaigns appear to be very helpful in increasing brand awareness and will likely to be permanently integrated into our multi-faceted promotional strategy.

Moving on to Slide No. 4, focus on quality and affordability. As we discussed last quarter, we began a television and radio campaign in seven cities primarily to increase brand awareness of APU. The initial program was successful at increasing overall organic traffic to our website and driving significant improvements and brand awareness especially within civilian communities.

Turning now to recent developments within the military community, the Department of Defense now mandates that online universities sign a memorandum of understanding, or an MOU, containing several new requirements for continued eligibility in the tuition assistance program. AMU is in compliance with these new requirements and has signed a new MOU which is effective January 1, 2012. Based on public statements made by Department of Defense officials, it appears the Department is considering possible changes to the military Tuition Assistance program, or TA, as a result of current and future budget constraints. While the DOD has not made any public statements with specific information on this matter, we believe modifications could include any or a combination of the following.

One, a reduction of the per-course tuition benefit which is currently \$250 per credit hour. Two, a decrease in the annual benefit which is currently \$4,500 per year. And/or three, require that service members pay out of pocket for a portion of their tuition among other possible changes. At this time the Company is not able to estimate the potential impact of a reduction or change to Military Tuition Assistance. It is also important to note that we estimate that most service members will be eligible for Title IV and Top Up to finance their out-of-pocket tuition costs.

Top Up is a program that allows service members to use a portion of their veterans' education benefits while still on active duty. Some enlisted soldiers may also be able to cover out-of-pocket tuition costs by using Pell grants although Pell grants may also be under pressure in the future.

Turning to regulatory matters, in a recent 8-K we announced that the Higher Learning Commission has reaffirmed APUS' accreditation without any stipulations on our affiliation status. APUS' next comprehensive evaluation is scheduled for the 2020 to 2021 academic year and it has an interim progress report regarding development of university-wide coordination and a review of graduate studies due in July 2015.

We are very pleased with this outcome and with other recent acknowledgments, including an award presented to Dr. Phil Ice our VP of Research and Development. In May, Dr. Ice was recognized with the Innovation in Distance Learning Administration Wagner Award at the 2011 Distance Learning Administration Conference. The Wagner Award recognizes the development of innovative solutions to the challenges of distance education including training issues, retention, evaluation, assessment and online services.

Today, the U.S.A. Council of the International Association of Emergency Managers, IAEM, announced the APUS is the 2011 winner of its Academic Recognition Award to be presented this November at IAEM's 59th Annual Conference. This award recognizes a U.S. academic institution that has made a significant contribution to the formal education of students pursuing a career in emergency management or through a research and development of standards that have helped shaped the broader field of emergency and disaster management. These awards illustrate the commitment of our distinguished faculty and staff to the success of APUS students, the academic community, and the professional communities we serve.

Moving to Slide 5 entitled Appropriate Investments in Quality and Long-Term Success. We also have many examples of how we build relationships and support organizations in the fields we teach. For instance, we recently announced a partnership with the National Association of Environmental Professionals, NAEP, to provide its members access to APU degree programs, including classes and degree programs covering environmental policy and management, stewardship of natural resources, pollution management, and global environmental sustainability.



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In support of these relationships and our students, we continue to invest in student services and infrastructure to support a larger student population. In the second quarter, we continued with our LMS conversion to Sakai which is still on track to be completed by the end of 2011. I want to acknowledge the massive efforts by faculty and staff to make this major systems' conversion successful through this point and time. While it is too early to measure the impact of Sakai on retention and outcomes, we have noted an increase in the level of collaboration in the classroom which is one of the predictors of retention. As part of our effort to convert to Sakai, we are investing in the expansion of support for mobile devices and other productivity tools as well.

We currently lease space at two facilities that house our IT infrastructure. In the fourth quarter, we plan to move our IT Disaster Recovery Site from Maryland to Texas in order to place our backup systems on a separate electric grid, further strengthening the reliability of our systems and our crisis management plan. As noted last quarter we continue to invest in the improvement of our FSA processing systems. We are currently implementing enhanced [Dundee] verification programs and processes for fraud detection and prevention.

In the second quarter of 2011, we launched eight new degree programs -- an AA and BA in Retail Management, a BS and MS in Accounting, an AA in Criminal Justice, an MS in Sports and Health Sciences, and a BA and a MA in Reverse Logistics. We believe that we are among the first universities to offer a degree program in Reverse Logistics. Our expertise in transportation logistics, retail management, environmental policy and our corporate relationships allowed us to be the first to market with a degree program in this emerging and rapidly growing professional field. We will continue to build new academic programs and concentrations in fields that will be attractive to both military and civilian students.

Moving on to Slide No. 6 entitled Conformance Creates Higher Standards Than Compliance. For a number of years now, we have recognized the need for transparency for prospective students, regulators and accreditors, as well as the need for research on the attendance and success patterns of adult students studying online. We were a charter member of the transparency by design initiative, along with the Capella University, American Intercontinental University, Colorado Technical University and Kaplan University. Later Argosy University, Ashford University, the University of the Rockies and Western International University joined this initiative which provides a mix of for-profits and non-profits as its members.

More recently we signed the Accord, a commitment to transparency, by 20 regionally accredited for-profit institutions. At this point in time, Strayer and APUS are the only signees of the Accord from the public company sector. Last quarter, WCET announced the Predictive Analytics for Online Student Retention project. Funded by the Gates Foundation, the project will examine the variables influencing student retention and progression for more than 400,000 online undergraduate students attending six institutions including the University of Phoenix and APUS.

While the first two initiatives are laudable for their commitment to transparency for prospective students, the most recent initiative is more important for several reasons. As you know, the for-profit sector has come under fire for supposedly emphasizing marketing over academic results. It is logical that improvement in quality and student outcome should enhance anyone's business model and it is time for more members of our sector to collaborate in research projects with non-profit and for-profit institutions serving similar students.

For example, I am hopeful that the WCET Predictive Analytics project will contribute to the research literature about adult students [enrolling] and will facilitate an open discussion with investors and regulators about best practices for removing barriers to adult student success online or face to face.

In closing, I am very pleased with our financial and operational performance this quarter, our 16th quarter reporting as a public company. Several years before we went public, we set out to build and manage APUS with a long-term perspective. I believe that the hard work and efforts of APUS' faculty, staff, trustees, and board are coming together at the right time for our students and for our country. APUS is built for a higher purpose, a mission that is underscored by our belief that if you always do what is best for students, everyone benefits.



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At this time, I will turn the call over to Harry Wilkins, our CFO, to review our financial results in greater detail. Harry?

**Harry Wilkins** - American Public Education, Inc. - EVP, CFO

Thanks, Wally. Referring to Slide 7, the second quarter of 2011 financial highlights, we had a tremendous start to this year and the strong trends we saw in the last quarter generally continued into the second quarter. American Public Education's second-quarter results include a 31% increase in revenues to \$60.8 million, compared to the second quarter of 2010. Revenue growth was driven primarily by a 28% increase in net course registrations, and a 39% increase in net course registrations from new students, as well as a slight benefit from the timing of starts during the quarter.

Operating income for the second quarter of 2011 increased 27% to approximately \$14.9 million, compared to the second quarter of 2010. Overall expenses as a percent of revenue increased slightly to 75.5%, compared to 74.7% year-over-year. Instructional costs and services as a percent of revenue increased slightly to 37.9%, compared to 37.6% in the prior period. Selling and promotional costs as a percent of revenue declined to 16% from 17.6% in the prior year period, as a result of seasonality and revenue outperformance in the second quarter of 2011.

G&A as a percent of revenue increased to 17.9%, compared to 16.1% in the prior year. As discussed last quarter, the G&A increase is largely the result of additional investment in our infrastructure, compliance and security, as well as to an increase in bad debt expense, which is now approximately 1.4% of revenue. Included in G&A are costs associated with the implementation of new program integrity rules, as well as costs related to our voluntary and proactive efforts to increase FSA abuse detection through a more rigorous identity verification process.

In addition to these compliance and security initiatives, we are making additional investments in IT, student services and administrative facilities to support a larger student population. This is reflection of our continued confidence in our future growth.

In the second quarter of 2011, our tax rate remained the same at 40% and net income increased 29% to \$9 million, or \$0.49 per diluted share, ahead of our expectations. We expect to file our second-quarter 10-Q on August 9. Meanwhile, I can share with you that our second-quarter 2011 cash balance was approximately \$94.5 million and we have no debt. Keep in mind that our cash balance was impacted by a \$5.4 million stock repurchase of 126,000 shares at a weighted average of \$42.55 during the second quarter.

Also impacting cash was a \$10.6 million payment of income taxes on April 15. Cash from operations for the six months ended June 30, 2011 was approximately \$25.7 million, compared to the \$18.2 million in the same period of 2010. Our CapEx was approximately \$6.8 million for the six months ended June 30, 2011, compared to \$8.5 million in the prior-year period. This run-rate is lower than originally expected due to some delays in the construction of our new finance facility in Charlestown. As a result, a portion of our budgeted CapEx for 2011 may flow into the year 2012.

Depreciation and amortization was \$4.3 million for the six months ended June 30, 2011, and \$3 million for the same period in 2010.

If you go to Slide 8, which is our third-quarter outlook. As a result of our continued success of civilian outreach, the long-term driver of our growth, and continued growth in the military, the Company expects net course registrations from new students in the third quarter of 2011 to increase approximately 35% year-over-year, and net course registrations to increase approximately 28% compared to the prior-year period.

We are pleased that net course registrations of the new students continue to be as strong, [configuratively] strong after a temporary lag last summer, which we believe was related to an unusually high level of troop deployment and transition. This bodes well for overall net course registration growth in the long run.



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APUS is an open enrollment institution and we believe that it is increasingly recognized as the university of choice for students seeking affordability. In this economy, we believe there is also an increase in the number of civilian students who recognize the attractiveness of the Federal Student Aid program to cover costs of living expenses while taking classes, and therefore are attracted to APUS because of our relatively low tuition. Many of these civilian course takers are completing courses successively, but it's difficult to estimate the persistence rate for this population because their main academic objectives may be courses and not necessarily degree completion.

Unfortunately, some individuals are attempting to abuse the system and we believe this is not currently a material number of students, but the instances of these students appear to be increasing. We are proactively ramping up our efforts to identify and prevent such potential abuse. These situations have always occurred in post-secondary institutions and have been a major focus of the National Association of Student Financial Aid Officers and Administrators, NASFAA, in developing best practices to prevent abuse.

At APUS we work with NASFAA, we work with the OIG, we work with the Department of Justice and other academic institutions to develop additional techniques and procedures in an effort to identify and prevent financial aid abuse.

The Company anticipates third-quarter 2011 revenue growth of approximately 29% compared to the prior-year period. Earnings per share for the third quarter 2011 are expected to be between \$0.41 and \$0.43 per diluted share.

In closing, APEI is in a strong financial position. We continue to experience strong growth as students increasingly recognize APUS for its quality and affordability. We believe our approach is the right model, especially during the time of economic uncertainty and rapid change that we're in. While managing for the long run with student success as our primary consideration, we are creating a sustainable model that appropriately serves all stakeholders.

Now at this time, we are happy to answer any questions. Operator, can you please open the line for questions?

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## QUESTIONS AND ANSWERS

### Operator

Thank you. (Operator Instructions). Our first question comes from the line of James Sanford with Citigroup. Please proceed.

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### James Sanford - Citigroup - Analyst

Thank you, just a quick question on your guidance. It looks like you're actually probably guiding to margin expansion in Q3, if my calculation is right at the midpoint. I'm just wondering is that from a function of more efficient marketing mix, or is there something else happening in terms of the military versus civilian mix that is reversing some of the prior trends? Thank you.

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### Harry Wilkins - American Public Education, Inc. - EVP, CFO

That's a very good question and we really have historically hesitated to give specific line-item guidance in our guidance, and we're probably not going to vary from that in this discussion. But we are seeing some margin improvement as you can see in the second quarter in Selling and Promotion, and we also as we grow the civilian business we do get a little economy from scale. But overall, the business is on target and we're meeting our goals. We are getting really strong growth, really stronger than expected in the civilian marketplace, and we're maintaining a really strong expected growth rate in the military. I guess that's all we're going to say on that.



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**Operator**

All right, our next question comes from the line of Ariel Sokol. Please proceed.

**Ariel Sokol** - UBS - Analyst

Hi, good afternoon, I have a modeling question as it relates to Q4 again. I'm not asking about guidance, just asking a little bit how to think about an issue which has impacted the Company's financials in the past. In November 2011, Monday starts on the 7th. November 2010, Monday starts on the 1st, and I think that this has been an issue kind of previously. If you can help us think about kind of forecasting out Q4 revenues, it would be very much appreciated.

**Wallace Boston** - American Public Education, Inc. - CEO, President

Yes. I mean we recognize -- our classes are eight weeks in length and we recognize revenue per day, on a daily basis. So when -- and then the classes start the first Monday of every month. So, when classes start November 1, we recognize more days' revenue in November than we do when they start November 7. That's a fact. So, just consider that when you're contemplating your numbers.

**Harry Wilkins** - American Public Education, Inc. - EVP, CFO

And those revenues will flow into the first quarter of next year for any eight-week class that starts in November or December.

**Ariel Sokol** - UBS - Analyst

Thank you.

**Operator**

Our next question comes from the line of Robert Craig with Stifel Nicolaus. Please proceed.

**Robert Craig** - Stifel Nicolaus - Analyst

Good afternoon, guys. Wally, I was wondering if you might be so kind as to provide an update on the Walmart relationship and maybe share some thoughts as to some of the additional resources you're channeling into building partnership relationships?

**Wallace Boston** - American Public Education, Inc. - CEO, President

Sure. Our Walmart relationship has been going well on both sides. We continue to perform on our end and evaluate different job positions for potential academic credit related to learning on the job. That's going on, on a timely basis. Walmart continues to promote the program internally. To the best of my knowledge has not decided on when they want to make a particular announcement about the corporate reimbursement. But we are happy with the relationship. There's no materiality in how many students are attending under the program, but we think it's a long-term program that over the long haul we'll be happy with.

As far as other corporate relationships, when we announced the Walmart transaction we had one corporate salesperson in our marketing department and now we have three. We've had a significant number of opportunities come to us through either

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brand awareness from advertising or perhaps the exposure we got from announcing the Walmart transaction, but we're staying very busy.

As I've said on other calls at some conference, our experience is that typically these corporate relationships take 12 to 14 months to firm up. So don't expect to have a slew of announcements all at once, but we'll continue to work on them. Like the BAE that we announced a quarter or two ago, I think we'll have a stream of them come in and we'll be pretty happy with them. I think we announced one today, the one with the environmental group. So, we're pretty happy with that.

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**Robert Craig** - *Stifel Nicolaus - Analyst*

Great. Thanks, Wally.

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**Operator**

Our next question comes from the line of Adrienne Colby with Deutsche Bank. Please proceed.

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**Adrienne Colby** - *Deutsche Bank - Analyst*

Hi. Thanks for taking my question. Last quarter your Selling and Promotional expenses increased year-over-year in part due to this I guess increased ad spend related to TV and radio programs. So it sounds like this effort has been successful and I think you said that the pilot program would be becoming part of your permanent ad spend. I was just hoping you could help us to reconcile that with the overall decline we saw in S&P as a percent of revs sequentially. I think you mentioned something about seasonality. We're just hoping you can give us a little bit more color on what to expect going forward.

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**Harry Wilkins** - *American Public Education, Inc. - EVP, CFO*

There is seasonality in our student registrations. In fact, whether it's the military or even the civilian, even though we offer semester starts on a monthly basis, the fall quarter is typically a popular time for course signups as well as the first part of the year in January or February. So, what we see is that typically in our marketing spend we need to plan out about 90 days in advance for leads to be generated and then for those leads to be generated into new students.

And so, in looking at what we know are seasonal trends, we plan for our spends accordingly 90 days out in advance. So, I think we know that September and October, which override two quarters, the third quarter and the fourth quarter, are expected to be big months for new students. And so we will be spending in all of our marketing initiatives, not just radio and TV, but online lead generation that we do ourselves roughly 90 days out.

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**Wallace Boston** - *American Public Education, Inc. - CEO, President*

We usually spend more money on marketing in the third quarter as a percentage of revenue. First of all, because revenue usually in the summertime is a little less than it is during the traditional school year for us. And we do spend a lot of money usually to try to ramp up for the fall enrollment period, which is a big enrollment period for us. So historically, that is true and those are historic trends.



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**Adrienne Colby** - Deutsche Bank - Analyst

If I can just sneak in a follow up, then I think you said that initially the pilot was rolled out in seven markets. So, are you planning to sort of roll this out nationally? Again, is this going to be sort of more of an integrated approach, or you have sort of another plan to do a large chunk or again, how to think about that?

**Wallace Boston** - American Public Education, Inc. - CEO, President

Well, we don't have the benefit of size that some of the larger participants in the sector do as far as going to a national campaign immediately. But we are going to add additional markets. And not only that, but you may or may not have noticed that the Neg Regs that were implemented on state regulations, some of the states are actually implementing tougher standards on whether or not you can advertise in a market if you're not located or not licensed in that area.

So, I believe the plan is to go from the 7 markets to 18 markets by the end of the year. So I don't know that I would call that a national rollout, but that's a significant presence for us. Once again, we'll continue to -- we try to watch our dollars with the overall goal being keeping our marketing spend under 20% and we've been pretty successful at doing that. So we'll continue to match the dollars up and make sure that we're generating not just leads, but generating the quality leads that we hope to become good students who continue to persist and ultimately graduate with us. So, that's the current plan.

**Adrienne Colby** - Deutsche Bank - Analyst

Thank you. I appreciate the color.

**Operator**

Our next question comes from the line of Peter Appert with Piper Jaffray. Please proceed.

**Peter Appert** - Piper Jaffray & Co. - Analyst

Thanks. So Wally, regarding the changes you mentioned, or possible changes in the TA program, do you have any additional color on that in terms of how we might think about timing on a decision around that? Specifically, if they were to reduce the benefit from the \$250 level, how would you think about the pricing for your offerings?

**Wallace Boston** - American Public Education, Inc. - CEO, President

Well, there's a couple of questions. You obviously had a couple of questions there, Peter, so I'll try to take them one on one. If we had anymore specificity, we would have announced it. I didn't want to say that our options were those that were rumored, but they're pretty much those that we've heard buzzing around the various services since we have a pretty good outreach team that has a lot of connections within the military branches.

It's our understanding that DOD does not want to negatively impact any service member, so whenever they reach a decision, whenever a signoff is made to whatever change is going to be made, they intend to give plenty of notice. By plenty of notice our guess, our best guess is that this is something that could take place around January 1, but the fiscal year also starts on October 1. I just don't think that's plenty of notice since there's been nothing publicized that we've received as of today.

As far as how we would adjust our thoughts about pricing, we haven't increased our tuition at the undergraduate level for 10 years, and very few colleges in America have done that. The bulk of the top 25 serving the military as far as institutions go or state institutions, which have been dramatically impacted by price. The VA Top Up program and financial aid are available for

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students. So, at this point in time I don't see -- our thinking about price is that we're going to recommend that students utilize these other programs, because we will continue to be flat for 10 years going on 11. But I don't see a negative adjustment.

**Peter Appert** - Piper Jaffray & Co. - Analyst

Okay. Thank you, Wally.

**Operator**

Our next question comes from the line of Bob Wetenhall with RBC Capital Markets. Please proceed.

**Bob Wetenhall** - RBC Capital Markets - Analyst

Hi, nice quarter. I just wanted to inquire, were you surprised by the strength of new net course registrations? I'm looking at your guidance. It's a pretty sizeable number. What gives you the confidence that you're going to continue to operate at that high level in the mid 30s?

**Wallace Boston** - American Public Education, Inc. - CEO, President

Well, one thing that gives us confidence is we've already completed the month of July and the month of August started yesterday, and while our free week of drops isn't over yet, we have a pretty good insight into trends, Bob. So, essentially making this call we're pretty comfortable that we know what two of the three months of the quarter are. So, that's the third quarter and that's what we're giving guidance on.

We also believe pretty strongly in our marketing studies where we asked our students how they heard about us and why they picked us, that the affordability is really resonating with students. In fact, it's resonating to an extent that we think people are hearing about us from sources that we're not sure where they're coming from yet, which is a good problem to have.

The bad problem is that when you have unknown sources you're not sure whether those students persist or not. So, we're hesitant to continue to predict whether we're going to have the same levels of retention and proven levels of retention that might be negatively impacted. But, we feel pretty good about the number that we gave you for the third quarter for new students.

**Harry Wilkins** - American Public Education, Inc. - EVP, CFO

We really do think that the trend is still moving online and moving toward more affordable programs online. We think we're sitting there as the market moves online with the most affordable programs of very high quality and the most variety of programs.

**Wallace Boston** - American Public Education, Inc. - CEO, President

The other thing I might add, I mean I just saw that they announced another increase in tuition for the fall of the University of California system of like 9.6%, and that was on top of an 8% increase that they announced in the spring for the fall. So you're looking at 17.6% increase, which I think means that the University of California in-state students are going to pay about \$13,000 and our tuition is at \$7,500. So we are in many, many states with the state budget crisis, we're becoming a very attractive, affordable option.

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**Bob Wetenhall** - RBC Capital Markets - Analyst

That makes sense. Just one follow up with what's transpired in D.C. and potential cuts to the Defense budget, do you think there is any chance that DOD funding of educational programs gets cut down the road?

**Wallace Boston** - American Public Education, Inc. - CEO, President

Well, there's a chance. I think anything is on the table with the budget cuts. But I would tell you that historically the military has used their support of college education as a substantial incentive to recruit service members. So whether it's the GI Bill benefit or the Tuition Assistance program, they talk about enlisting and earning a degree at the same time. If you talk to military recruiters, it's not just recruits that they're trying to convince of the story, but it's also their parents.

So, the form of how the reimbursement changes could change, I mean they could elect that all of the benefit comes through the GI Bill, for example. That's not my job to speculate as much as just to share with you that that sort of thing could happen. But we think because the benefit has been in place since World War II, that some form of benefit is going to stay. It's vital and it's part of the culture. And the form it takes, we'll continue to monitor it and try to responsive to the needs of our students.

**Bob Wetenhall** - RBC Capital Markets - Analyst

Understood, thanks very much and good luck.

**Wallace Boston** - American Public Education, Inc. - CEO, President

Sure, thanks.

**Operator**

Our next question comes from the line of Corey Greendale with First Analysis. Please proceed.

**Corey Greendale** - First Analysis Securities - Analyst

Hi, good afternoon.

**Wallace Boston** - American Public Education, Inc. - CEO, President

Hi.

**Corey Greendale** - First Analysis Securities - Analyst

Question about the sources of students, how students are finding you. So I know that you generally get a lot of students from relationships. How many of your students, or however you can break it out into new students or tell if students are coming from more just open market lead generation? And then can you talk about trends there? Are you seeing anything in that smaller piece of your business that some of the others in the space have seen negative trends?

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**Wallace Boston** - American Public Education, Inc. - CEO, President

Corey, we give our referral percentage once a year, because it's so difficult to track month to month and quarter by quarter. What we have said in the past is that our civilian students have a lower referral rate than our military students. So naturally, we're going to spend a little more to generate the leads on that. But the good news is that our type of relationship marketing is such that whether it's a field like transportation logistics or our new degree, for example, in reverse logistics which we just put up, those are designed through our faculty members and industry advisors on councils that we have to generate referrals.

So I believe that the last time we gave a number on referrals is that the overall number was about 40% referrals. And you know as far as our cost for lead generation, it's less than 5% of our ad spend. So we're not using much still on outside lead gen and I guess would caution people if anybody happened to read today's Chronicle of Higher Education. There's still some what I would call borderline lead gen companies that anyone is using in a significant manner ought to take a look at who they're using and what they're doing.

**Corey Greendale** - First Analysis Securities - Analyst

And it looks like it may take a while for that totally flush out. The other question I was going to ask you is if you look at Slide 5, you talk about some investments you're making. Are any of those the type of things where we should expect some more meaningful ramps in spending over the next couple of quarters?

**Wallace Boston** - American Public Education, Inc. - CEO, President

Harry, do you want to answer that?

**Harry Wilkins** - American Public Education, Inc. - EVP, CFO

Yes, I think that the similar-type spend that we've incurred is what you could expect as a percentage of revenue. Our CapEx is actually running a little bit behind what we budgeted.

**Wallace Boston** - American Public Education, Inc. - CEO, President

Yes, but on the one building that we're currently under construction we just had a problem getting a permit, which delayed second-quarter budgeted expenditures into what is now the third quarter, but we're still going to spend roughly the same amount of money to build the building that we planned on spending.

**Corey Greendale** - First Analysis Securities - Analyst

Okay. I would think that with your green initiatives and all that they'd be happy -- that you'd be on the fast track for approvals, but I understand so thanks.

**Wallace Boston** - American Public Education, Inc. - CEO, President

Okay. Thanks, Corey.

**Operator**

Our next question comes from the line of Jeff Silber with BMO Capital Markets. Please proceed.



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**Jeffrey Silber** - BMO Capital Markets - Analyst

Thanks so much. Harry, I have to apologize to you. Towards the end of your talk I kind of tuned out for a second. You were talking about financial aid abuse. Can you just give us a little bit more color on what you were speaking of? Should we be expecting some announcement along those lines? Any help would be appreciated. Thanks.

**Harry Wilkins** - American Public Education, Inc. - EVP, CFO

Yes, no announcement. What we're seeing we wanted to let our investors know that we're seeing -- and I'm sure it's because of the economy and I've seen it before in our industry. When people lose their jobs and they get that one way to get by for a few months is to actually go and sign up for classes at a school. When you have a school with a tuition as low as ours, and the same thing happens at most community colleges, when your tuition is below the federal borrowing limit students can borrow money, more money than they need to attend and they can live off that money for a few months.

Now, we're not seeing material numbers now and we plan to stay ahead of this. Actually, you're kind of limited to what you can do to prevent it, because it's perfectly legal. But we just wanted to warn our investors that we have a number of people taking courses with us and they sign up for classes and they're there for a while, but they may not -- they're really not even seeking to graduate. It's just like a temporary economic way for them to get by for a few months if they're between jobs and they haven't found their job or unemployment runs out, something like that.

So, we're seeing a little bit more of that, we think, than normal. But it's not something that we're really worried about but we're focusing our attention on and we try to restrict it as much as we can within the federal requirements.

**Wallace Boston** - American Public Education, Inc. - CEO, President

Jeff, I would add two additional things to what Harry just said. You may have seen that the Department said that they were going to begin a trial program where schools could restrict borrowing to their cost of attendance rather than what students want to borrow. We've sent a formal email to the Department indicating our desire to participate in that trial program. We've been informed that they'll send out -- they'll have RFP process which they haven't developed. They don't have a date for it to start, but we're actually convinced that that's the appropriate way to go.

Even though some people might say well you might lose students that way, we'd rather have our students graduate with a low loan balance reflecting the cost of attendance rather than the cost of living or the cost of them repaying their credit cards. The other thing that I would add in this WCET Gates Initiative, the schools that are participating in that have had informal discussions about the fact that all of them and four of the six schools or state schools, which have lower tuitions like us, that all of them are seeing signs of that.

So if there's a way to tease out some data to isolate a particular group of students that are doing exactly what Harry says; they're going to school for a while to take care of the financial aid, or to take advantage of the financial aid ability to borrow more. Hopefully, that data will indicate that and whenever results are published we'll have a comment about that. But the bottom line is that we're trying to do what's best for all the stakeholders and it's just as important to do the right thing for the Federal Student Aid Program as it is for us as it is for our students.

**Jeffrey Silber** - BMO Capital Markets - Analyst

All right, it's very helpful. Thanks and I'd just sneak in a quick numbers' question. What tax rate and share count are embedded in your third-quarter guidance?

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**Harry Wilkins** - American Public Education, Inc. - EVP, CFO

Actually, it's 40%. And the share count we're about halfway through our buyback, so I wouldn't expect it to be maybe 25,000 shares or so less.

**Jeffrey Silber** - BMO Capital Markets - Analyst

Okay great, thanks so much.

**Operator**

Our next question comes from the line of Amy Junker with Robert W. Baird & Co. Please proceed.

**Amy Junker** - Robert W. Baird & Co. - Analyst

Hi, thanks. I'm just looking at the revenue per student and noticed that was up a bit in the quarter, and looks like given the guidance it's going to be up again in the third quarter. Given you haven't raised tuition prices, is that a function of combining the lab credit with the three-credit course, or is there something else that could be driving that and are you expecting that to continue for the foreseeable future?

**Wallace Boston** - American Public Education, Inc. - CEO, President

Actually, Amy, if you remember from last quarter, we had revenues from last quarter that spilled over into this quarter sort of related to what Ariel was asking us about the question about November start, of November 1 versus -- or November 7 versus November 1 a year so. So really, I don't think it's increased per student as much as it's just timing of revenue recognition.

**Harry Wilkins** - American Public Education, Inc. - EVP, CFO

It is. It's really timing of the revenue recognition versus the start.

**Amy Junker** - Robert W. Baird & Co. - Analyst

Then, if I can just sneak one more in. Related to 90/10 there's been a lot of talk about including Department of Defense funds towards that 90%. What has been your stance, or I guess your argument against that? If that were to change immediately I don't think you'd be in risk of violating it, but how would you think about that?

**Wallace Boston** - American Public Education, Inc. - CEO, President

Well, our argument against it is that we don't sign a contract with the military to send all of their service members to us. It's an individual choice. So, I happened to think the 90/10 rule is the wrong rule anyway. It's a rule that impacts everyone because of a few bad actors going back in history, and obviously you have your ideologues who think it should apply to everyone. But, it's just sad that you have rules like that. My feeling about it, if it were included, right now we have 14% cash so we have a little bit of cushion.

At the same time, you might naturally say, well there're going to be some players that are going to over 90%. So more than likely, if they're charging less to the military, they're probably going to opt out of that market. If those students were to come



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to us, then I guess at some point it theoretically could tip us over. So when we have our conversations on the Hill we just say, look, we've been serving this market for 20 years. We didn't get into serving the military market because we had a 90/10 problem. We're built to serve this market from the beginning. We would hope that if such an initiative is considered that there will be exceptions for certain schools that were built to serve the military and have served the military well with no complaints and with positive plaudits over the years. So that's our approach.

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**Amy Junker** - Robert W. Baird & Co. - Analyst

Thanks, guys.

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**Operator**

Our next question comes from the line of Arvind Bhatia with Sterne, Agee. Please proceed.

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**Arvind Bhatia** - Sterne, Agee & Leach, Inc. - Analyst

Okay, thank you. I know one of you said you were satisfied with the active duty military growth of 9% this quarter, but it was a bit of a slowdown versus the first quarter of plus 16%. That was, I think, against slightly easier comparison as well. Is this what we should continue to model going forward?

Again, in the fourth quarter of last year you had a little bit of acceleration. I'm just trying to understand what your view is in the near future kind of in terms of growth in that segment. Then, I have another question as well.

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**Harry Wilkins** - American Public Education, Inc. - EVP, CFO

I think we had implied guidance for the year of in the single digits, so our 16% in the first quarter was clearly above what we had targeted. I think the 9% is pretty much in line with what our expectations were. Our size is such now that I would expect single-digit growth numbers to be good numbers, simply because of the law of large numbers and the fact that the military market itself is still not growing.

If we get the true productions, we think we'll see some increases in the military market absent some type of a tuition reduction that would impact it as well. But for right now, we think single-digit growth is what people can expect. But, I mean, at our size single-digit growth in terms of absolute numbers is a pretty nice increase in numbers of students.

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**Wallace Boston** - American Public Education, Inc. - CEO, President

Our growth hinges on civilian students. There's no question about that. And civilian students continue to be our -- where we think the growth is going to come from in the future and we continue to exceed our expectations in our civilian growth so far this year.

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**Arvind Bhatia** - Sterne, Agee & Leach, Inc. - Analyst

Right, then I guess similarly in VA as well, the growth decelerated from 59% in the first quarter to 21%. Help us understand how we should be thinking over the rest of the year.

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**Wallace Boston** - American Public Education, Inc. - CEO, President

Well, the VA is sort of a crapshoot. That's probably a poor choice of words, but what's weird about VA is that up until August 1 our students were eligible for no housing allowance. Effective August 1, there's a 50% housing allowance for distance education students, which is a lot better than where we were before. At the same time under the rumored issue with TA, if let's say they implement a 75/25 where they'll pay 75% and the student has to pay 25%, in the past students have been eligible for Top Up for that and we don't expect that to change.

So you would actually see an increase in VA utilization, but you may not see -- you may actually see a lowering of the dollars because the Top Up is a different program than the regular tuition program. So VA, I would think that having the 50% housing allowance effective August 1 is going to be a benefit to us and it's too soon to predict what might happen on the Top Up side with the TA. Harry, have you got any thoughts on that?

**Harry Wilkins** - American Public Education, Inc. - EVP, CFO

Yes. I mean we expect the VA to continue to grow and, again, we think we're happy with the growth rate of our VA program. The law of numbers is starting to impact that a little bit. Last year, we were growing on a very small base of VA students. The number of our VA students is getting to be fairly significant now. So, with 20-some percent growth it's actually pretty good in VA students.

**Arvind Bhatia** - Sterne, Agee & Leach, Inc. - Analyst

One last one from me. In light of the calendar and you are certainly now in the fourth quarter and marketing spend that you've planned, etc., should we be thinking of margin expansion in the fourth quarter as well similar to those third-quarter guidance?

**Wallace Boston** - American Public Education, Inc. - CEO, President

Yes, again, we're not going to give guidance for the fourth quarter. We're giving guidance one quarter at a time these days and we're not going to give specific line item guidance either. So, we're right on target with where we think we're going to be and we're giving third-quarter guidance that we're comfortable with. You guys are really smart and you have good models and you'll figure that out.

**Arvind Bhatia** - Sterne, Agee & Leach, Inc. - Analyst

Great, thank you.

**Operator**

Our next question comes from the line of Brandon Dobell with William Blair. Please proceed.

**Brandon Dobell** - William Blair & Company - Analyst

Hey, guys, good afternoon.

**Wallace Boston** - American Public Education, Inc. - CEO, President

Hey, Brandon.



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**Brandon Dobell** - *William Blair & Company - Analyst*

I wonder if you could address, I guess it's called the opportunity or your thoughts around programmatic accreditation, whether you will be looking at more of those types of things; whether you plan on going into areas where you maybe can differentiate your programs a little bit more with a specific programmatic accreditation, if there is any major cost that we should think about associated with those efforts?

**Wallace Boston** - *American Public Education, Inc. - CEO, President*

Well, there are always costs. We built them into our standard operating model. I believe we have approximately six program accreditations. Our most recent one was in the second quarter when we issued a press release about our ACBSP accreditation for our business program. We will also be seeking [NCAD] accreditation for our education programs. That takes a while to go through that process. And we are currently a candidate for specialty accreditation for our Masters in Public Health degree, which we expect to have a visit sometime in the first quarter of next year.

The other ones, we're accredited by the National Council on Family Relations; the Foundation for Higher Education Accreditation, which is our Emergency Management Program; the American Sports Education Program for our Sports Management Program; and SHRM for our Human Resource Management Program; and the accreditor for the Masters in Public Health is the Council of Education for Public Health, CEPH.

So, we continue to look at that. If we were to launch an engineering degree, it would absolutely be a requirement of probably the HLC that within a certain period of time we seek ABET accreditation for that. Specialty accreditation is very important, particularly if you're trying to compete against the public institutions, which we've always told you all that that's our primary source of competition.

**Brandon Dobell** - *William Blair & Company - Analyst*

Okay and kind of sideline of that, any color on the mix of graduate versus undergraduates students and, if possible, any color on the mix within your civilian population how that's trending these days?

**Wallace Boston** - *American Public Education, Inc. - CEO, President*

By degree, I think the graduate students are roughly in the low 20s as they've been. I think they might have been 24% a year ago and they're about 22% now and it's because we've had higher growth. It's not because they're not growing. We just had higher growth in the undergraduate programs and that's probably related to the economy. I said at the beginning the changes in the economy that we had deferred submitting our doctoral degrees for approval because we felt that in this economy doctoral degrees were a luxury and not a necessity. I think masters' degrees -- the good news is we have a number of masters' degrees.

But I think while we have a substantial number of students, the last time I looked at an actual count it was over 14,000, which is a very large graduate program. It just wasn't growing as fast as the undergraduate program.

What's going to be interesting is this new budget. It's my understanding that Congress is going to take away the interest subsidy on student loans for grads. So that would tell me that if I'm going into a grad program I'm going to look for a school with a lower-cost graduate program because of that issue about now deferral on my student loan interest.

**Brandon Dobell** - *William Blair & Company - Analyst*

That makes sense. Okay, thanks a lot.

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**Operator**

Our next question comes from the line of Kelly Flynn with Credit Suisse. Please proceed.

**Kelly Flynn - Credit Suisse - Analyst**

Thanks. Just a couple of follow-up comments on things you said. First of all, what you just said about the elimination of the graduate student interest subsidy. Can you elaborate on your view on that? I mean it sounds like from what you just said you think it will have an impact on demand more broadly across the sector. But if you have any thoughts on that it would be helpful, and then I have a follow up.

**Wallace Boston - American Public Education, Inc. - CEO, President**

Well, my first thought is that Congress chose to keep the Pell intact at \$5,500 versus spreading sort of the pain across the board. So they found a convenient way. It was my understanding that it was the Administration's proposal to reduce that subsidy to the graduate programs. I still believe that unfortunately it has really been too easy for students to receive federal aid and not fully understand the impact of what they're borrowing. We certainly have been big on transparency and disclosure. But, there is some truth that if you make it real, real easy I think people forget about what they're going to have to pay back at the end.

So, I would think that all of us are going to have to get better on that and the tuition cost calculators that are required to be in place for all institutions, for-profits and non-profits, by October 1 I would think will have to be adjusted to reflect the fact that interest is going to accrue and not be subsidized on graduate loans. Which will mean that some institutions are going to be flagged out as being more expensive than other institutions. So I don't see it necessarily reducing demand for us since our graduate degrees are even lower as a percentage of the public institutions who we compare ourselves to than the undergraduate degrees. But I do think higher-cost graduate degrees are going to possibly be impacted by this, particularly once that tuition cost calculator is out on everybody's website on October 1.

**Kelly Flynn - Credit Suisse - Analyst**

Okay, it makes sense. And then the second question relates to what you said about the stipend abuse. I'm wondering did that get worse when the year-round Pell was put in place? Related to that, what impact if any do you see, I guess, on broader-sector demand as a result of the elimination of the year-round Pell?

**Wallace Boston - American Public Education, Inc. - CEO, President**

Well, we don't have a high percentage of Pell. Our Pell percentage is single digits. I think 7.6% for the second quarter, or yes, roughly 7.6% of our total revenue was Pell. So, I think that there were very few students that were able to take advantage of the second supplement, mainly because you've got to be taking classes to apply for a second one. I think there's a segment of people who qualify for Pell who take just enough classes to qualify for Pell rather than accelerating their programs.

So I don't think that's as much of abuse as the situation where people sign low-cost programs like community colleges and like us where the tuition is below the insured loan limits. Then, tack on to that the fact if they ask for dollars beyond the cost of attendance, by law we're required to give it to them. I think that's the bigger source of abuse and that's what we've been talking about and noticing those trends and actually trying to put program in place to identify those people in advance, as well as we applied to be in that trial program. I think the whole reason there's a trial program is the Department of Education is recognizing that it is an issue nationwide as well. So hopefully, we'll get picked to be in that trial program

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**Kelly Flynn** - *Credit Suisse - Analyst*

Okay, sounds good. Thanks a lot.

**Wallace Boston** - *American Public Education, Inc. - CEO, President*

Thanks.

**Operator**

Our next question comes from the line of Thomas Allen with Morgan Stanley. Please proceed.

**Thomas Allen** - *Morgan Stanley - Analyst*

Hi, guys. Going back to the potential tuition assistance cuts, of the three scenarios you outlined any way you could rank for us which would have the most and least impact on revenue?

**Wallace Boston** - *American Public Education, Inc. - CEO, President*

I don't know that any of them will have an impact on revenue. The key thing is how do the military students view the complexity of having to find two payment sources versus one. Because unless the Top Up program for the GI bill changes, that allows you to take out-of-pocket costs for tuition; i.e., if there was 75/25 reimbursement versus 100%. And students use the Top Up now. So it's not like no one's using it. If you were able to attend a prestigious private institution that charges three times the tuition that we attend, you can use your Top Up to pay for the amount beyond the military tuition benefit.

So, the program's in place. There are a fair number of students who are using it, so it's not like the educational service officers are not familiar with Top Up. To me, it's more of an issue of how much of a pain in the butt is it for particularly the new student to use this and their desire to use it and that's just really unpredictable. I mean in my opinion it would be up to the military to provide the proper advice for people that -- you know what, the first time you're going around with the Top Up program it could take you up to 90 days to get approved to get into the program. But once you're in the program, renewing it is pretty easy.

There are number of people who we -- I mean we have students who use it for various reasons now. Like if you're a captain and you use TA, you have to extend your commitment to the military by two years. So we have some captains now who use Top Up rather than using the Tuition Assistance program. So it's just -- it's unpredictable, but because there's coverage I really wouldn't rank any of it as far as probability or a negative impact. I would say it is just -- it's too soon to know without seeing how students view the hassle factor.

**Harry Wilkins** - *American Public Education, Inc. - EVP, CFO*

We haven't seen that much of an impact at the graduate level. Our graduate tuition has exceeded what the military reimburses for TA, for Tuition Assistance for a number of years. Students have just used other financing methods, whether it's the Department of Education funds or whether it's the VA funds to make up the difference. We anticipate that's what the undergraduate students would do.

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**Thomas Allen** - Morgan Stanley - Analyst

Okay, so I show that's really on demand, but it sounds like from what you're saying that you don't expect that to have any impact. So okay, thanks.

**Operator**

All right, ladies and gentlemen, that'll conclude the Q&A portion of the call. I'd now like to turn the presentation back over to Mr. Chris Symanoskie for closing remarks.

**Chris Symanoskie** - American Public Education, Inc. - Director of IR

Thanks, Jeff. This will conclude our call for today. We wish to thank all of today's callers for their participation and interest in American Public Education. Thank you and have a great evening.

**Operator**

Ladies and gentlemen, that concludes today's conference. Thank you for your participation and have a great week.

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