

APOLLO GROUP: IS THERE CAUSE FOR CONCERN?

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FIN540 Week 3 Assignment

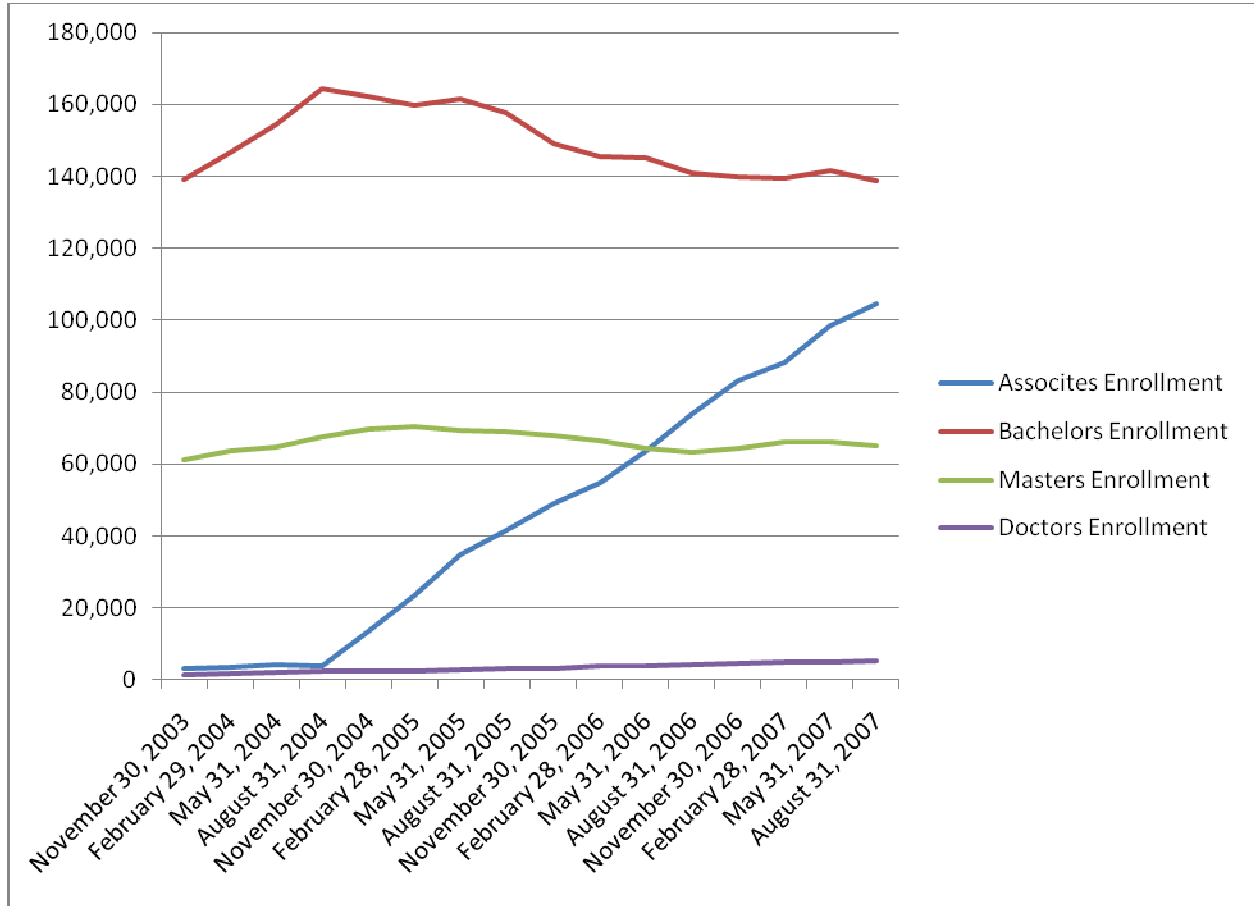
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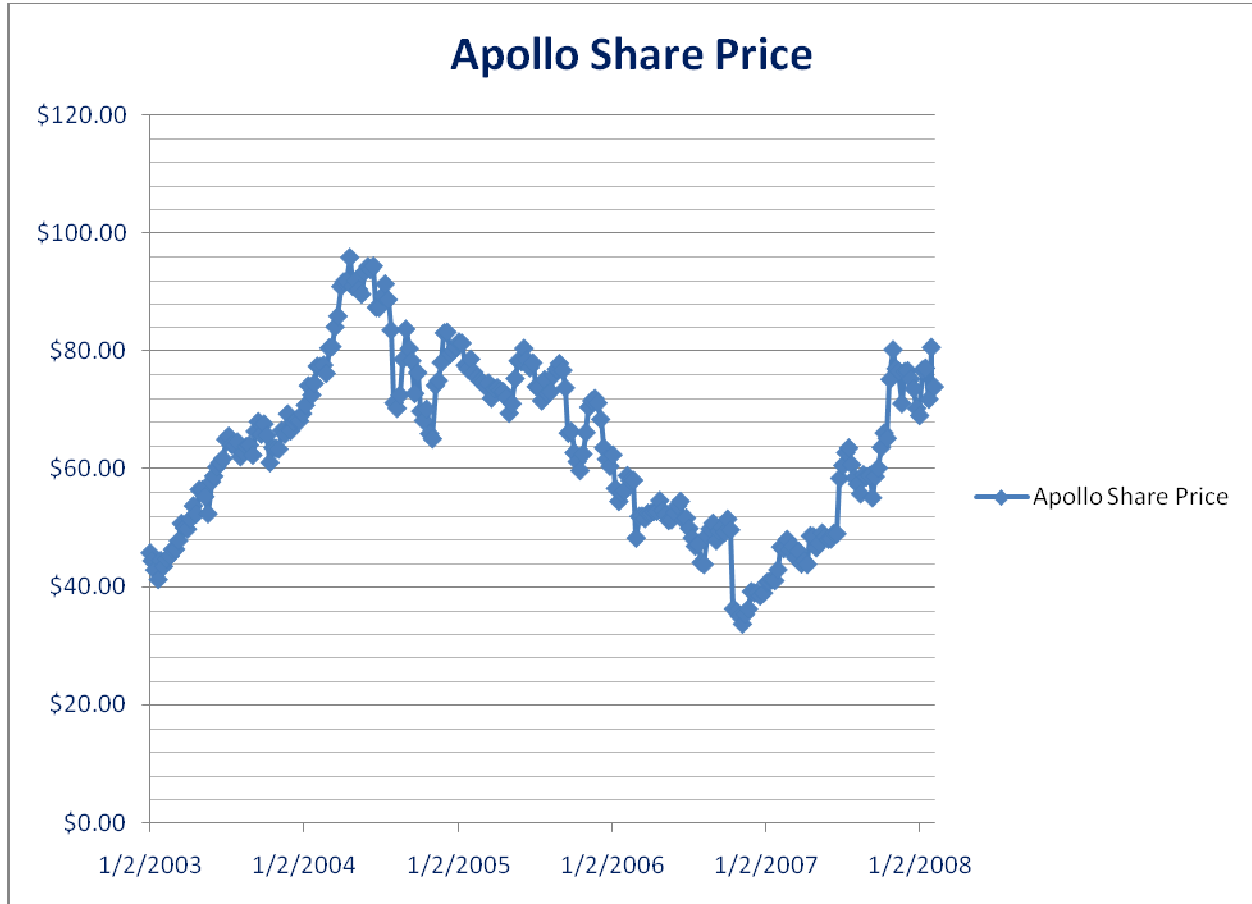
Insider Selling

What does it mean when the insiders are dumping their stock? During 3 days in January of 2008, John Sperling founder of Apollo Group dumped 685,825 shares of Apollo stock for \$54,760,000 dollars. Since the close of the fiscal 2007 year on August 31, 2007, John's son Peter Sperling has unloaded 994,722 shares for a total of \$77,360,602. These transactions followed John Sperling's disposition of 1 million shares in non-open market transactions during fiscal 2007. (Yahoo, 2008) Are these sales by the company founder and his son the result of things we do not know, or simply a rational response to a rising stock price after years of lack-luster performance? While I cannot answer this question in this paper, there is a story to be told about a company's dramatic response to its poor performance in the market.

Well after most of the dot coms went bust, Apollo Group, the nation's largest private institution of higher learning and the leader in online education defied gravity as its stock price continued to climb. Despite the recession of 2001, or maybe because of it, enrollment at Apollo Group's University of Phoenix continued to climb and climb, blowing past the 200,000 student mark in 2003. In April of 2004, the stock price peaked at more than \$95 per share. While the enrollment numbers continued to climb, they also masked a secret. Enrollment in the universities more profitable University of Phoenix programs had stalled and all of the growth was in the less profitable associate's degree program, then known as Western International University (now Axia). This chart shows the enrollment patterns since the latter part of 2003. The blue line shows the growth in Axia enrollments.

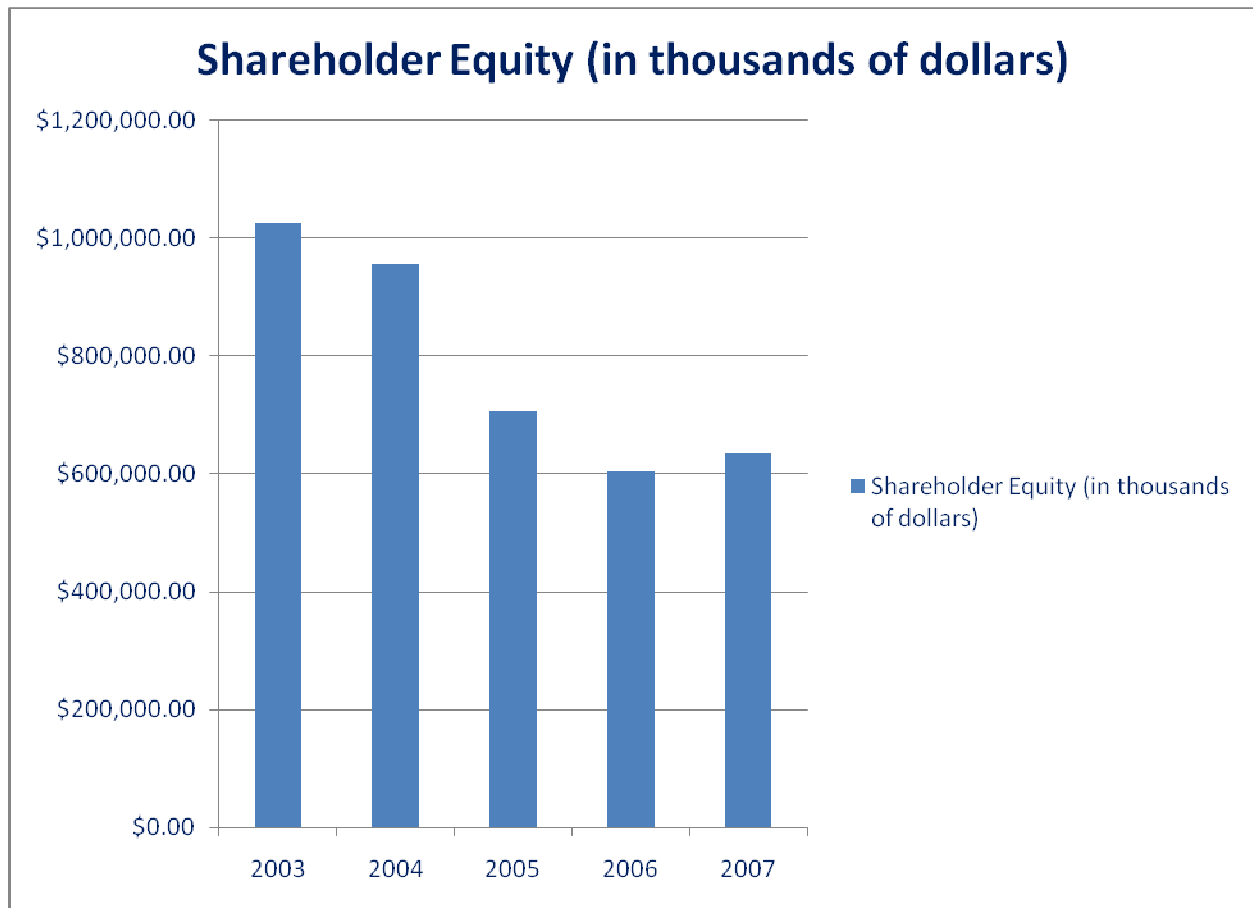


As enrollments peaked and declined in the University of Phoenix Bachelor and Master degree programs, the price of the stock also began to fall. This chart shows Apollo Group's stock price from 2003 through the present.



Apparently, in an effort to halt the slide, Apollo Group executives embarked on a massive effort to buy back shares. The balance sheet for the fiscal year ended August 31, 2004 shows no balance for Treasury Shares. However, the balance sheet for the fiscal year 2005 shows a balance of **(\$645,742,000)** for Class A Treasury Shares. The effect of this massive expenditure to repurchase stock and drive up the price was a reduction in shareholder equity of \$250 million, despite the fact that Apollo generated \$428 million in net income during fiscal 2005 and paid nothing out in dividends. In fiscal 2006 and 2007, the treasury share balances increased by an additional \$408 million and \$407 million respectively. This was nearly the entire net income amounts for those years. In other words, from fiscal 2005 through fiscal 2007, Apollo Group earned \$1,268,331,000 in net income, but spent \$1,461,368,000 buying back its own stock. The

result was a decline in shareholder equity during this period, despite record profits and no dividend payments.



The share price did bottom out in November of 2006 in the low thirty dollar range and climbed throughout 2007, until it was again flirting with a price of \$80 per share. Was the stock buy back program a success? The stock price is now higher than it has been in years. However, the logic of such a program escapes me. It seems much like the Keynesian demand stimulation theory, which dominated economics for several decades. The problem is a lack of demand for the stock and the way to fix the problem is to throw \$1.5 billion at the problem. I am a supply sider myself, and I have to wonder what the long-term effects could have been if the \$1.5 billion in earnings would have been used for facilities, support services, curriculum development, new technologies, retaining better faculty, marketing, expanding into new markets, etc., etc.

What the Ratios Say

The ratio analysis paints an interesting picture and did what a ratio analysis should do. It caused me to ask questions. I have given specific descriptions of the ratios and what they meant in my spreadsheets, so I will address the bigger picture in this paper. They generally show a financially sound organization, with little debt and a high level of profitability. There is nothing in the ratios which is alarming. However, the direction in which the leverage and liquidity ratios moved from 2003 to 2007 is troubling. Declining shareholder equity caused the leverage ratios to move in the direction of a more highly leveraged company, although still at a low level. Interestingly, the industry as a whole seems to use very little leverage. This is probably because it is an industry which does not require much in the way of fixed costs. The primary asset for a university is in its faculty, which is not reflected on the balance sheet.

Likewise, the liquidity ratios are not at a level that cause great concern, unless they were to continue to trend downward and place the university in danger of not being able to timely meet its obligations. I have to assume that Apollo management would not be foolish enough to continue on such a trajectory.

Apollo really shines when it comes to the profitability ratios. The profitability ratios are several times higher than competitors. Arguably, the reduction in assets and equity caused by the stock repurchase program increase the ROA and ROE levels. However, had the \$1.5 billion been invested in assets which would have produced a return the net income earned by Apollo would have been greater. Assuming that the law of diminishing returns applied, arguably the ROA and ROE percentages would have been lower. But, they would have been lower based on a larger net income amount in absolute terms.

What Management is Saying to Shareholders

The Letter to Shareholders is found at the front of the Annual Report. Below I discuss some of the statement found in the 2007 letter signed by John Sperling Acting Executive Chairman of the Board and Founder, and Brian Mueller, President. The letter states:

Financially, our achievements resulted in net income of \$408.8 million, or \$2.35 per diluted share, on consolidated revenue of \$2.7 billion, a 9.9% increase over fiscal 2006. Average quarterly degreed enrollments grew by 10.5%, and we ended the fiscal year with 313,700 students enrolled in our degree programs. We continue to generate positive cash flow as well, and ended the year with \$339 million in unrestricted cash.

However, the letter fails to say that the \$408.8 million in net income was actually a \$6 million decline over fiscal 2006. It also fails to state that they took nearly the entire \$408 million and repurchased Apollo shares with the money. Enrollments did grow by more than 10% during fiscal 2007, but the statement fails to tell the reader that nearly all of the growth was in the Axia associate degree program, while other programs were stagnant. Apollo did end the year with \$339 million in unrestricted cash, but they do not say that unrestricted cash declined from \$416 million in 20003, when it was 30% of assets on the balance sheet. The \$339 million in unrestricted cash is only 23% of the asset total on the balance sheet.

The Greatest Threat is Risky, Short-term Thinking

Looking over the record of the last few years, the greatest danger I see for the future is the short-term perspective taken by management. I strongly agree that shareholder value should be the primary focus of a corporation. Since shareholders have a residual claim against the assets of the company, they only receive value after everyone else in line has been paid. It is the final position of shareholders that causes a focus on shareholder value to create strong and successful

companies, which produce the goods and services desired by their customers. But, shareholder value and temporarily popping the stock price are not the same thing.

Apollo Group has relied heavily on stock options as an incentive for management. It is often thought that options give management an “equity” interest in the corporation. However, owning an option is very different from owning a share of stock in two ways. First, options expire while shares do not. Second, shares have both an upside and a downside, options have only an upside. These differences create a short-sighted view and encourage excessive risk-taking.

Since your options normally expire in 3 to 5 years from the date they are issued, either the price increases during that time period, or the option holder is left with a worthless piece of paper. To avoid this fate, executives must think of short-term ways to pop the stock. It is not particularly important that the price stay high, it must simply go high so that the options can be exercised.

Since options only have value above the strike price, an option holder is no worse off if the price tanks and is \$20 below the strike price than if the stock is one penny below the strike price. However, the option holder receives all of the upside. Thus, the option holder is 2 times better off if the price is \$20 above the strike price than he is if the stock is selling at \$10 above the strike price. This lack of exposure to the downside and the amplified gain received on the upside, encourage undue risk taking. Risk is often thought to be associated with the volatility of a stock. The farther it tends to swing into the positive, the farther it tends to swing into the negative. The owner of a share of stock benefits from the swing into the positive, but is hurt by the swing into the negative. Thus, he is somewhat risk averse. He knows that unduly risky strategies can hurt him if they fail. In contrast the option holder is a risk seeker. He benefits

greatly if his decisions cause the corporate stock to swing widely into positive territory but pays no price when his decision causes the stock price to fall below the strike price on his options.

Thus, the over use of options to reward management at Apollo place the corporation in danger, because they encourage management to look for the short-term pop in the stock price and the promote policies that are unduely risking to increase the volitility of the stock price and the degree to which the stike might temporarily exceed the strike price of their options.

Apollo Global

I am particularly intrigued by the Apollo Global initiative set forth in the 2007 Annual Report. I teach in the Online international program and believe that there is a strong demand for adult educational services in many parts of the world. Apollo has agreed to a joint venture with the Carlyle Group to invest \$1 billion in secondary educational businesses outside the U.S. The Annual Report lists the following reasons for this initiative.

The decision to create Apollo Global was driven by the following factors:

- Attractive demographics and economic growth in the targeted international markets, primarily Latin America and Asia. According to World Bank estimates, there will be over 175 million post-secondary students outside the U.S. by the year 2035;
- Strong foreign demand for and high value placed on the U.S. educational system;
- The ability to leverage our 30+ years of experience in providing education services, and transfer this expertise to companies that are acquired or developed in foreign markets;
- Increasing U.S. barriers to foreign students seeking entry visas to study in the U.S.;
- The opportunity to benefit from our leading technology platform by offering our online products and services in new markets, and by making this technology and online delivery platform available to companies that we acquire;

- The opportunity to diversify through the acquisition and development of new businesses and brands; and
- A desire to mitigate economic and geographic risk associated with a primarily domestic business.

While I have been critical of the stock purchase program in this paper, because it did nothing to promote the future of the company and failed to increase shareholder value, the Apollo Global initiative does precisely the opposite. It seeks to commit resources in a way that will create greater value for the future. If successful, it provides the opportunity to greatly increase the number of students who attend the University of Phoenix, and to do so over the very long-term.

I also think that it has the potential to add greater value to the brand name inside the US and well as overseas. It provides the university with a chance to be a world leader in education, as well as a leader in the US. From my experience teaching in the Online International program, I know that the developing world is particularly underserved by institutions of higher learning. As many countries in the developing world continue to grow economically, the opportunities available to Apollo Global will also grow. It really sets up the potential for a virtuous circle, because the services that Apollo Global can provide to such countries will also further facilitate their economic growth.

References

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