

CAPELLA EDUCATION CO

FORM 10-Q (Quarterly Report)

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2007

or

☐ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from _____ to _____

Commission File Number: 001-33140

CAPELLA EDUCATION COMPANY

(Exact name of registrant as specified in its charter)

Minnesota
*(State or other jurisdiction of
Incorporation or organization)*

41-1717955
*(I.R.S. Employer
Identification No.)*

**225 South Sixth Street, 9th Floor
Minneapolis, Minnesota 55402**
(Address, including zip code, of principal executive offices)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ☐ Accelerated filer ☐ Non-accelerated filer ☒

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

The total number of shares of common stock outstanding as of October 26, 2007, was 17,227,818.

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PART I – FINANCIAL INFORMATION

Item 1. Financial Statements

CAPELLA EDUCATION COMPANY Consolidated Balance Sheets

	As of September 30, 2007	As of December 31, 2006
	(Unaudited)	
	(In thousands, except par value)	
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 41,462	\$ 22,491
Marketable securities	83,220	65,170
Accounts receivable, net of allowance of \$904 at September 30, 2007 and \$1,119 at December 31, 2006	7,066	7,401
Prepaid expenses and other current assets	5,887	3,703
Deferred income taxes	1,783	1,800
Total current assets	139,418	100,565
Property and equipment, net	34,014	28,749
Total assets	\$ 173,432	\$ 129,314
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 3,017	\$ 5,113
Accrued liabilities	24,229	18,598
Income taxes payable	—	214
Deferred revenue	8,270	7,488
Current portion of capital lease obligations	—	5
Total current liabilities	35,516	31,418
Deferred rent	1,336	1,813
Capital lease obligations	—	7
Deferred income taxes	1,933	2,331
Total liabilities	38,785	35,569
Shareholders' equity:		
Common stock, \$0.01 par value:		
Authorized shares — 100,000		
Issued and outstanding shares — 16,947 at September 30, 2007 and 16,002 at December 31, 2006	169	160
Additional paid-in capital	183,657	156,513
Accumulated other comprehensive income (loss)	53	(7)
Retained earnings (accumulated deficit)	(49,232)	(62,921)
Total shareholders' equity	134,647	93,745
Total liabilities and shareholders' equity	\$ 173,432	\$ 129,314

The accompanying notes are an integral part of these consolidated financial statements.

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CAPELLA EDUCATION COMPANY Consolidated Statements of Income

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
	(Unaudited)			
	(In thousands, except per share amounts)			
Revenues	\$55,530	\$43,902	\$162,272	\$129,278
Costs and expenses:				
Instructional costs and services	24,759	20,131	72,869	61,473
Marketing and promotional	17,583	14,967	52,753	42,540
General and administrative	6,865	4,741	19,364	15,115
Total costs and expenses	49,207	39,839	144,986	119,128
Operating income	6,323	4,063	17,286	10,150
Other income, net	1,253	1,123	3,477	3,094
Income before income taxes	7,576	5,186	20,763	13,244
Income tax expense	2,514	2,145	7,074	5,506
Net income	<u>\$ 5,062</u>	<u>\$ 3,041</u>	<u>\$ 13,689</u>	<u>\$ 7,738</u>
Net income per common share:				
Basic	<u>\$ 0.30</u>	<u>\$ 0.26</u>	<u>\$ 0.83</u>	<u>\$ 0.66</u>
Diluted	<u>\$ 0.29</u>	<u>\$ 0.25</u>	<u>\$ 0.80</u>	<u>\$ 0.64</u>
Weighted average number of common shares outstanding:				
Basic	<u>16,810</u>	<u>11,731</u>	<u>16,411</u>	<u>11,691</u>
Diluted	<u>17,611</u>	<u>12,063</u>	<u>17,177</u>	<u>12,021</u>

The accompanying notes are an integral part of these consolidated financial statements.

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CAPELLA EDUCATION COMPANY Consolidated Statements of Cash Flows

	Nine Months Ended September 30,	
	2007	2006
	(Unaudited) (In thousands)	
Operating activities		
Net income	\$ 13,689	\$ 7,738
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for bad debts	2,583	2,026
Depreciation and amortization	7,277	6,046
Amortization of investment discount (premium)	139	(236)
Asset impairment	31	23
Stock-based compensation	2,532	2,720
Noncash equity-related expense	—	224
Excess tax benefits from stock-based compensation	(3,942)	(28)
Deferred income taxes	(423)	(654)
Changes in operating assets and liabilities:		
Accounts receivable	(2,248)	(2,001)
Prepaid expenses and other current assets	(348)	(1,101)
Accounts payable and accrued liabilities	5,021	(76)
Income taxes payable	3,128	2,811
Deferred rent	(477)	(409)
Deferred revenue	782	1,378
Net cash provided by operating activities	27,744	18,461
Investing activities		
Capital expenditures	(14,070)	(11,132)
Purchases of marketable securities	(178,154)	(163,782)
Sales of marketable securities	160,067	151,732
Net cash used in investing activities	(32,157)	(23,182)
Financing activities		
Payments of capital lease obligations and notes payable	(1)	(2,189)
Excess tax benefits from stock-based compensation	3,942	28
Net proceeds from exercise and repurchase of stock options	8,527	(108)
Net proceeds from issuance of common stock	10,916	—
Employee Stock Ownership Plan distributions	—	(6)
Net cash provided by (used in) financing activities	23,384	(2,275)
Net increase (decrease) in cash and cash equivalents	18,971	(6,996)
Cash and cash equivalents at beginning of period	22,491	13,972
Cash and cash equivalents at end of period	\$ 41,462	\$ 6,976
Supplemental disclosures of cash flow information		
Interest paid	\$ —	\$ 22
Income taxes paid	\$ 4,354	\$ 3,348
Noncash transactions:		
Purchase of equipment through capital lease obligations	\$ —	\$ 16
Purchase of equipment included in accounts payable and accrued liabilities	\$ 592	\$ 1,771
Retirement of equipment financed through capital lease obligations	\$ 11	\$ —
Issuance of common stock to the Employee Stock Ownership Plan	\$ —	\$ 1,241

The accompanying notes are an integral part of these consolidated financial statements.

CAPELLA EDUCATION COMPANY
Notes to Consolidated Financial Statements
(In thousands, except per share data)

1. Nature of Business

Capella Education Company (the Company) was incorporated on December 27, 1991. Through its wholly-owned subsidiary, Capella University (the University), the Company manages its business on the basis of one reportable segment. The University is an online post-secondary education services company that offers a variety of bachelor's, master's and doctoral degree programs primarily delivered to working adults. Capella University is accredited by The Higher Learning Commission and is a member of the North Central Association of Colleges and Schools (NCA).

2. Summary of Significant Accounting Policies

Consolidation

The consolidated financial statements include the accounts of the Company and the University, after elimination of all intercompany accounts and transactions.

Unaudited Interim Financial Information

The accompanying unaudited consolidated financial statements of the Company have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, these statements include all adjustments (consisting of normal recurring adjustments) considered necessary to present a fair statement of our consolidated results of operations, financial position and cash flows. Operating results for any interim period are not necessarily indicative of the results that may be expected for the full year. Preparation of the Company's financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts in the financial statements and footnotes. Actual results could differ from those estimates. This Quarterly Report on Form 10-Q should be read in conjunction with the Company's consolidated financial statements and footnotes included in its Annual Report on Form 10-K for the fiscal year ended December 31, 2006 (2006 Annual Report on Form 10-K).

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Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates.

Contingencies

The Company accrues for costs associated with contingencies including, but not limited to, regulatory compliance and legal matters when such costs are probable and reasonably estimable. Liabilities established to provide for contingencies are adjusted as further information develops, circumstances change, or contingencies are resolved. The Company bases these accruals on management's estimate of such costs, which may vary from the ultimate cost and expenses associated with any such contingency.

3. Net Income Per Common Share

Basic net income per common share is based on the weighted average number of shares of common stock outstanding during the period and, since our preferred stock participated in receipt of dividends equally to common stockholders, also reflects the dilutive effects of the outstanding shares of our preferred stock. Diluted net income per common share increases the shares used in the per share calculation by the dilutive effects of options and warrants.

The table below is a reconciliation of the numerator and denominator in the basic and diluted net income per common share calculation.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
	(Unaudited)			
Numerator:				
Net income	\$ 5,062	\$ 3,041	\$13,689	\$ 7,738
Denominator:				
Denominator for basic net income per common share — weighted average shares outstanding	16,810	11,731	16,411	11,691
Effect of dilutive stock options and warrants	801	332	766	330
Denominator for diluted net income per common share	17,611	12,063	17,177	12,021
Basic net income per common share	\$ 0.30	\$ 0.26	\$ 0.83	\$ 0.66
Diluted net income per common share	\$ 0.29	\$ 0.25	\$ 0.80	\$ 0.64

Options to purchase 80 and 918 common shares, respectively, were outstanding but not included in the computation of diluted net income per common share in the three months ended September 30, 2007 and 2006, respectively, because their effect would be antidilutive. Options to purchase 43 and 696 common shares, respectively, were outstanding but not included in the computation of diluted net income per common share in the nine months ended September 30, 2007 and 2006, respectively, because their effect would be antidilutive.

4. Income Taxes

The Company adopted the provisions of FASB Interpretation No. 48 *Accounting for Uncertainty in Income Taxes — an interpretation of FASB Statement No. 109* (FIN 48) on January 1, 2007. As a result of the implementation of FIN 48, the Company recognized no adjustment in the liability for unrecognized income tax benefits. At the adoption date of January 1, 2007, the Company had \$269 of total gross unrecognized tax benefits. Of this total, \$175 (net of the federal benefit on state issues), represents the amount of unrecognized tax benefits that, if recognized, would favorably affect its effective income tax rate in future periods. There were no material adjustments for the unrecognized income tax benefits in the nine months ended September 30, 2007.

The Company is subject to U.S. federal income tax as well as income tax of multiple state jurisdictions. Currently, no jurisdictions are under examination.

The Company continues to recognize interest and penalties related to uncertain tax positions in income tax expense. Upon adoption of FIN 48, the Company had less than \$1 of accrued interest related to uncertain tax positions.

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For federal purposes, tax years 1998-2006 remain open to examination as a result of earlier net operating losses being utilized in recent years. The statute of limitations remains open on the earlier years for three years subsequent to the utilization of net operating losses. For state purposes, the statute of limitations remains open in a similar manner for states that have generated net operating losses.

The Company does not anticipate any significant increases or decreases in unrecognized tax benefits within the next twelve months. Immaterial amounts of interest expense will continue to accrue. In September of 2007, the statute of limitations expired on federal issues related to tax years 1995-1997. There was no material impact on the unrecognized tax benefits related to the expiration of the statute of limitations for tax years 1995-1997.

5. Accrued Liabilities

Accrued liabilities consist of the following:

	As of September 30, 2007 (Unaudited)	As of December 31, 2006
Accrued compensation and benefits	\$ 8,521	\$ 3,618
Accrued instructional fees	4,435	4,470
Accrued vacation	1,277	1,047
Customer deposits	1,614	1,218
Other	8,382	8,245
	<u>\$ 24,229</u>	<u>\$ 18,598</u>

6. Litigation

In the ordinary conduct of business, the Company is subject to various lawsuits and claims covering a wide range of matters, including, but not limited to, claims involving learners or graduates and routine employment matters. The Company does not believe that the outcome of any pending claims will have a material adverse impact on its consolidated financial position or results of operations.

7. Stock-Based Compensation

The table below reflects our stock-based compensation expense recognized in the consolidated statements of income for the three and nine months ended September 30, 2007 and 2006:

	Three Months Ended September 30, 2007		Nine Months Ended September 30, 2007	
	2007	2006 (Unaudited)	2007	2006
Instructional costs and services	\$ 257	\$ 250	\$ 844	\$ 701
Marketing and promotional	157	86	485	317
General and administrative	386	277	1,203	1,702
Stock-based compensation expense included in operating income	800	613	2,532	2,720
Tax benefit	191	105	608	654
Stock-based compensation expense, net of tax	<u>\$ 609</u>	<u>\$ 508</u>	<u>\$ 1,924</u>	<u>\$ 2,066</u>

The total stock-based compensation expense recognized during the three and nine months ended September 30, 2006 included (\$85) and \$808, respectively, of compensation expense related to performance-based stock options. The total income tax benefit recognized during the three and nine months ended September 30, 2006 included (\$32) and \$301, respectively, of income tax (expense) benefit related to performance-based stock options. The Company recorded a reduction in stock-based compensation expense and income tax benefit related to performance options in the three months ended September 30, 2006 due to a change in the estimate of the number of options that would vest. There has been no stock-based compensation expense recognized in 2007 for performance-based stock options.

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The tables below summarize stock option activity and other stock option information for the periods indicated:

	Available for Grant	Plan Options Outstanding		Weighted- Average Exercise Price per Share
		Incentive	Non-Qualified	
Service-based Stock Options				
Balance, December 31, 2006	1,978	978	1,010	\$ 16.46
Granted	(185)	—	185	42.13
Exercised	—	(320)	(206)	13.43
Canceled	43	(27)	(31)	19.74
Balance, September 30, 2007 (unaudited)	<u>1,836</u>	<u>631</u>	<u>958</u>	20.33
Performance-based Stock Options				
Balance, December 31, 2006		1	189	\$ 20.00
Exercised		(1)	(77)	20.00
Balance, September 30, 2007 (unaudited)		<u>—</u>	<u>112</u>	20.00
	Number of Shares	Weighted- Average Exercise Price	Weighted- Average Remaining Contractual Term	Aggregate Intrinsic Value
Service-based Stock Options				
Balance at September 30, 2007 (unaudited)	1,589	\$ 20.33	6.5	\$56,563
Vested and expected to vest, September 30, 2007 (unaudited)	1,502	\$ 20.06	6.5	\$53,856
Exercisable, September 30, 2007 (unaudited)	763	\$ 16.43	5.7	\$30,108

The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value (the difference between the Company's closing stock price on September 30, 2007 and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on September 30, 2007. The amount of aggregate intrinsic value will change based on the fair market value of the Company's stock.

Restricted stock activity for the nine months ended September 30, 2007 is summarized as follows:

	Number of Shares	Weighted- Average Grant Date Fair Value per Share
Restricted Stock		
Balance, December 31, 2006	—	\$ —
Granted	1	51.69
Vested	—	—
Forfeited	—	—
Balance, September 30, 2007 (unaudited)	<u>1</u>	\$ 51.69

During the year ended December 31, 2006, the Company granted performance-based stock options to purchase 255 shares of common stock at a weighted-average exercise price per share of \$20.00. At December 31, 2006, 74.5% of these performance-based stock options vested and were exercisable based on meeting certain performance thresholds related to planned revenue and income before income taxes. The remaining 25.5% of these performance-based stock options were canceled. The outstanding performance-based stock options had a weighted-average remaining contractual life of 8.4 years and an aggregate intrinsic value of \$4,053 at September 30, 2007.

The following table summarizes information regarding all stock option exercises for the nine months ended September 30, 2007 (unaudited):

Proceeds from stock options exercised	\$ 8,527
Tax benefits related to stock options exercised	5,379
Intrinsic value of stock options exercised	16,110

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Intrinsic value of stock options exercised is estimated by taking the difference between the Company's closing stock price on the date of exercise and the exercise price, multiplied by the number of options exercised for each option holder and then aggregated.

As of September 30, 2007, total compensation cost related to nonvested service-based stock options not yet recognized was \$7,358, which is expected to be recognized over the next 28 months on a weighted-average basis.

8. Regulatory Supervision and Oversight

The University is subject to extensive regulation by federal and state governmental agencies and accrediting bodies. In particular, the Higher Education Act (HEA) and the regulations promulgated thereunder by the U.S. Department of Education (DOE) subject the University to significant regulatory scrutiny on the basis of numerous standards that schools must satisfy to participate in the various types of federal learner financial assistance under Title IV Programs.

To participate in the Title IV Programs, an institution must be authorized to offer its programs of instruction by the relevant agencies of the state in which it is located, accredited by an accrediting agency recognized by the DOE and certified as eligible by the DOE. The DOE will certify an institution to participate in the Title IV Programs only after the institution has demonstrated compliance with the HEA and the DOE's extensive academic, administrative, and financial regulations regarding institutional eligibility. An institution must also demonstrate its compliance with these requirements to the DOE on an ongoing basis.

The Company performs periodic reviews of its compliance with the various applicable regulatory requirements. The Company has not been notified by any of the various regulatory agencies of any significant noncompliance matters that would adversely impact its ability to participate in Title IV programs, however, the Office of Inspector General (the OIG) of the Department of Education has conducted a compliance audit of the University. The OIG is responsible for, among other things, promoting the effectiveness and integrity of the Department of Education's programs and operations. The audit commenced on April 10, 2006 and the Company subsequently provided the OIG with periodic information, responded to follow up inquiries and facilitated site visits and access to the Company's records. The OIG completed its field work in January 2007 and the Company received a draft audit report on August 23, 2007. The draft audit report is preliminary, and is subject to further review and revision by the OIG. The Company provided written comments on the draft audit report to the OIG on September 25, 2007. At some time in the future, the OIG's final report will be issued to the Acting Chief Operating Officer for Federal Student Aid, who will subsequently issue final findings and requirements for the University. The most significant potential financial exposure from the audit pertains to repayments to the Department of Education that could be required if the OIG concludes that the Company did not properly calculate the amount of Title IV funds required to be returned for learners that withdrew from Capella University without providing an official notification of such withdrawal and without engaging in academic activity prior to such withdrawal. If it is determined that the University improperly withheld any portion of these funds, the University would be required to return the improperly withheld funds. For the three year audit period, and for the 2005-2006 aid year, the Company estimates that the total amount of Title IV funds not returned for learners who withdrew without providing official notification was less than \$1.0 million, including interest, but not including fines and penalties.

Political and budgetary concerns significantly affect the Title IV Programs. Congress reauthorizes the HEA and other laws governing Title IV Programs approximately every five to eight years. The last reauthorization of the HEA was completed in 1998. Although the process for reauthorization of the HEA is underway, there is no assurance on when or if it will be completed. Because reauthorization has not yet been completed in a timely manner, Congress has extended the current provisions of the HEA through March 31, 2008. Additionally, Congress reviews and determines appropriations for Title IV programs on an annual basis through the budget and appropriations processes. As of September 30, 2007, programs in which the Company's learners participate are operative and sufficiently funded.

As an exclusively online university, the "50% Rule," enacted in 1992, would preclude the Company's learners from participating in Title IV programs. However, the 50% Rule was repealed (effective July 1, 2006) as part of the Higher Education Reconciliation Act, which was part of the Deficit Reduction Act signed into law by President Bush on February 8, 2006. The Deficit Reduction Act is currently being challenged in court by private plaintiffs alleging that the act is invalid due to discrepancies between non-education related provisions of the House and Senate bills. Although the legal challenges do not relate to the 50% Rule, an invalidation of the Deficit Reduction Act could reinstate the provisions of the 50% Rule. Therefore, should the plaintiffs prevail in the pending litigation, the Company may need to find alternative ways of either qualifying for Title IV or providing alternative student financing vehicles.

In addition to the DOE and state higher education regulatory bodies, other governmental entities exercise oversight authority over our business practices. In April 2007, the Company received inquiries from the New York and Minnesota Attorneys General in connection with their ongoing reviews of financial aid practices at various colleges and universities. As part of its inquiry, the New York Attorney General requested information regarding the relationship between Student Loan Express, one of 15 institutions currently listed by the Company as a recommended student lender, and Timothy Lehmann, the Company's former Director of Financial Aid.

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On May 15, 2007, the Company announced settlements with the attorneys general of New York and Minnesota. In connection with these settlements, the Company has adopted a code of conduct recently established by the New York Attorney General, which is similar to our existing financial aid practices. The Company did not pay any fines or restitution in connection with these settlements.

On April 19, 2007, the Company received a letter of inquiry from U.S. Senator Edward Kennedy, Chairman of the Senate Health, Education, Labor and Pensions Committee (HELP Committee), related to the Committee's oversight of the federally-guaranteed student loan program. The Company has responded to this inquiry, which appeared to focus on similar issues to those raised by the New York Attorney General. On June 14, 2007, the HELP Committee released its "Report on Marketing Practices in the Federal Family Education Loan Program." While the Committee's inquiry into Capella has not officially concluded, the Company has received no further requests for information or to appear before the Committee.

On May 21, 2007, the Company received a letter of inquiry from the OIG. This inquiry focused on similar issues to those raised by the Attorneys General and Senator Kennedy's committee, and the Company met with OIG personnel in July 2007 and provided documentation to the OIG to respond to their inquiry. The Company has received no further requests for information regarding this inquiry from the OIG since the initial response and meeting.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion of our historical results of operations and our liquidity and capital resources should be read in conjunction with the consolidated financial statements and related notes that appear elsewhere in this report.

Forward-Looking Statements

Statements contained in this Quarterly Report on Form 10-Q that are not statements of historical fact should be considered forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 (the "Act"). In addition, certain statements in our future filings with the Securities and Exchange Commission, in press releases, and in oral and written statements made by us or with our approval that are not statements of historical fact constitute forward-looking statements within the meaning of the Act. Examples of forward-looking statements include, but are not limited to, statements regarding: proposed new programs; regulatory developments; projections, predictions, expectations, estimates or forecasts as to our business, financial and operational results and future economic performance; and statements of management's goals and objectives and other similar expressions concerning matters that are not historical facts. Words such as "may," "should," "could," "would," "predicts," "potential," "continue," "expects," "anticipates," "future," "intends," "plans," "believes," "estimates" and similar expressions, as well as statements in future tense, are intended to identify forward-looking statements, but are not the exclusive means of identifying such statements.

Forward-looking statements involve risks and uncertainties that may cause actual results to differ materially from those in such statements. Factors that could cause actual results to differ from those discussed in the forward-looking statements include, but are not limited to, those described in "Risk Factors" in Part I, Item 1A of our Annual Report on Form 10-K for the fiscal year ended December 31, 2006, as updated in our Form 10-Q for the quarter ended March 31, 2007, and other subsequent reports filed with the SEC, including any updates found in Part II, Item 1A of this report on Form 10-Q. The performance of our business and our securities may be adversely affected by these factors and by other factors common to other businesses and investments, or to the general economy. Forward-looking statements are qualified by some or all of these risk factors. Therefore, you should consider these risk factors with caution and form your own critical and independent conclusions about the likely effect of these risk factors on our future performance. Such forward-looking statements speak only as of the date on which statements are made, and we undertake no obligation to update any forward-looking statement to reflect events or circumstances after the date on which such statement is made to reflect the occurrence of unanticipated events or circumstances. Readers should carefully review the disclosures and the risk factors described in this and other documents we file from time to time with the Securities and Exchange Commission (SEC).

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Overview

Background

We are an exclusively online post-secondary education services company. Our wholly owned subsidiary, Capella University, is a regionally accredited university that offers a variety of undergraduate and graduate degree programs primarily delivered to working adults. At September 30, 2007, we offered over 870 courses and 19 academic programs with 101 specializations at the graduate and undergraduate levels to approximately 20,300 learners.

We were founded in 1991, and in 1993 we established our wholly owned university subsidiary, then named The Graduate School of America, to offer doctoral and master's degrees through distance learning programs in management, education, human services and interdisciplinary studies. In 1995, we launched our online format for delivery of our doctoral and master's degree programs over the Internet. In 1997, our university subsidiary received accreditation from the North Central Association of Colleges and Schools (later renamed The Higher Learning Commission of the North Central Association of Colleges and Schools). In 1998, we began the expansion of our original portfolio of academic programs by introducing doctoral and master's degrees in psychology and a master of business administration degree. In 1999, to expand the reach of our brand in anticipation of moving into the bachelor's degree market, we changed our name to Capella Education Company and the name of our university to Capella University. In 2000, we introduced our bachelor's degree completion program in information technology, which provided instruction for the last two years of a four-year bachelor's degree. In 2001, we introduced our bachelor's degree completion program in business administration. In 2004, we introduced our four-year bachelor's degree programs in business administration and information technology, as well as three master's level specializations in education targeted at K-12 teachers. In 2005, we introduced two master's level specializations in education targeted to higher education and K-12 teachers as well as a master's in business administration specialization in accounting. In 2006, we introduced seven specializations including healthcare management, accounting and information assurance and security. Additionally, in November 2006, we completed an initial public offering of our common stock. During the nine months ended September 30, 2007, we introduced six new programs and 27 new specializations.

Critical Accounting Policies and Use of Estimates

Our critical accounting policies are disclosed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2006. During the nine months ended September 30, 2007, there have been no significant changes in our critical accounting policies.

Results of Operations

The following table sets forth statements of operations data as a percentage of revenues for each of the periods indicated:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Revenues	100.0%	100.0%	100.0%	100.0%
Costs and expenses				
Instructional costs and services	44.6	45.9	44.9	47.6
Marketing and promotional	31.6	34.0	32.5	32.9
General and administrative	12.4	10.8	11.9	11.7
Total costs and expenses	88.6	90.7	89.3	92.2
Operating income	11.4	9.3	10.7	7.8
Other income, net	2.3	2.6	2.1	2.4
Income before income taxes	13.7	11.9	12.8	10.2
Income tax expense	4.5	4.9	4.4	4.3
Net income	9.2%	7.0%	8.4%	5.9%

Three Months Ended September 30, 2007 Compared to Three Months Ended September 30, 2006

Revenues. Our revenues for the three months ended September 30, 2007 were \$55.5 million, representing an increase of \$11.6 million, or 26.5%, as compared to revenues of \$43.9 million for the three months ended September 30, 2006. Of this increase, 22.5 percentage points were due to increased enrollments and 4.7 percentage points were due to the impact of pricing increases, which was partially offset by a 0.8 percentage point decrease due to a larger proportion of master's learners, who generated less revenue per learner than our doctoral learners. End-of-period enrollment increased 23.8% in 2007 compared to 2006.

Instructional costs and services expenses. Our instructional costs and services expenses for the three months ended September 30, 2007 were \$24.8 million, representing an increase of \$4.6 million, or 23.0%, as compared to instructional costs and services expenses of \$20.1 million for the three months ended September 30, 2006. This increase was primarily due to an increase in learner support services and increases in instructional pay as a result of the increase in enrollments. Our instructional costs and

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services expenses as a percentage of revenues decreased by 1.3 percentage points to 44.6% for the three months ended September 30, 2007, as compared to 45.9% for the three months ended September 30, 2006. This decrease in 2007 was primarily due to a decrease in the ratio between faculty compensation and revenue and increased efficiencies in our information technology department, partially offset by an increase in bonus expense due to a higher expected payout in 2007 than in 2006.

Marketing and promotional expenses. Our marketing and promotional expenses for the three months ended September 30, 2007 were \$17.6 million, representing an increase of \$2.6 million, or 17.5%, as compared to marketing and promotional expenses of \$15.0 million for the three months ended September 30, 2006. This increase was driven by greater spending in targeted marketing and online media and an increase in recruitment and marketing staffing. Our marketing and promotional expenses as a percentage of revenues decreased by 2.4 percentage points to 31.6% for the three months ended September 30, 2007, from 34.0% for the three months ended September 30, 2006. This improvement reflects both proportionately greater marketing spending in the first half of 2007 when compared to 2006 and efficiency improvements across marketing enrollment spending.

General and administrative expenses. Our general and administrative expenses for the three months ended September 30, 2007 were \$6.9 million, representing an increase of \$2.1 million, or 44.8%, as compared to general and administrative expenses of \$4.7 million for the three months ended September 30, 2006. This increase was primarily attributable to increases in costs related to being a public company, an increase in bonus expense due to a higher expected payout in 2007 than in 2006, and higher legal costs. A significant portion of our legal costs for the three months ended September 30, 2007 related to increased pre-trial activity in on-going litigation initiated by a former learner, which litigation includes both his claims against us and our counterclaims against him. This litigation against us, alleging inadequate access to our courserooms under federal and state disability laws is scheduled for trial in November 2007, as is an appeal on our counterclaim for defamation and interference with business relations. Our general and administrative expenses as a percentage of revenues increased by 1.6 percentage points to 12.4% for the three months ended September 30, 2007, from 10.8% for the three months ended September 30, 2006 due to an increase in bonus expense, public company expenses and increased legal costs as discussed above, offset by a decrease in certain contingency expenses.

Other income, net. Other income, net increased by \$0.1 million, or 11.6%, to \$1.3 million for the three months ended September 30, 2007, from \$1.1 million for the three months ended September 30, 2006. The increase was principally due to increased levels of interest income on higher average cash and marketable securities balances, partially offset by lower levels of interest income from investing exclusively in tax-exempt investments in the third quarter of 2007.

Income tax expense. We recognized tax expense for the three months ended September 30, 2007 and 2006 of \$2.5 million and \$2.1 million, respectively, or at effective tax rates of 33.2% and 41.4%, respectively. The decrease in our effective tax rate in the third quarter of 2007 from 2006 was primarily due to the increased use of tax-exempt investments, a decrease in the impact of non-deductible FAS 123(R) stock-based compensation expense for incentive stock options and a decrease in the amount of non-deductible meals and entertainment expenses.

Net income. Net income was \$5.1 million for the three months ended September 30, 2007, compared to net income of \$3.0 million for the three months ended September 30, 2006, an increase of \$2.0 million, because of the factors discussed above. Overall our bonus expense in the three months ended September 30, 2007 is higher than the same period in the prior year because of the higher expected payout of the bonus in 2007 and because we granted performance-based stock options in lieu of a cash bonus for certain executives in 2006.

Nine Months Ended September 30, 2007 Compared to Nine Months Ended September 30, 2006

Revenues. Our revenues for the nine months ended September 30, 2007 were \$162.3 million, representing an increase of \$33.0 million, or 25.5%, as compared to revenues of \$129.3 million for the nine months ended September 30, 2006. Of this increase, 23.1 percentage points were due to increased enrollments and 3.4 percentage points were due to the impact of pricing increases, which was partially offset by a 1.0 percentage point decrease due to a larger proportion of master's learners, who generated less revenue per learner than our doctoral learners. End-of-period enrollment increased 23.8% in 2007 compared to 2006.

Instructional costs and services expenses. Our instructional costs and services expenses for the nine months ended September 30, 2007 were \$72.9 million, representing an increase of \$11.4 million, or 18.5%, as compared to instructional costs and services expenses of \$61.5 million for the nine months ended September 30, 2006. This increase was primarily due to an increase in learner support services and increases in instructional pay as a result of the increase in enrollments, as well as an increase in information technology expenses and depreciation due to the implementation of additional modules of our enterprise resource planning system, and an increase in bonus expense due to a higher expected payout in 2007 than in 2006. Our instructional costs and

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services expenses as a percentage of revenues decreased by 2.7 percentage points to 44.9% for the nine months ended September 30, 2007, as compared to 47.6% for the nine months ended September 30, 2006. This decrease in 2007 was driven by improvements in our variable cost structure due to ongoing work on process improvements, including more efficient course scheduling and use of faculty, a decrease in the ratio between faculty pay and revenue, and a higher mix of capitalized software projects versus expense projects in 2007 as compared to 2006.

Marketing and promotional expenses. Our marketing and promotional expenses for the nine months ended September 30, 2007 were \$52.8 million, representing an increase of \$10.2 million, or 24.0%, as compared to marketing and promotional expenses of \$42.5 million for the nine months ended September 30, 2006. This increase was driven by greater spending in online media and an increase in recruitment and marketing staffing. Our marketing and promotional expenses as a percentage of revenues decreased by 0.4 percentage points to 32.5% for the nine months ended September 30, 2007, from 32.9% for the nine months ended September 30, 2006 due to efficiency improvements across marketing enrollment spending, partially offset by an increase in bonus expense due to a higher expected payout in 2007 than in 2006.

General and administrative expenses. Our general and administrative expenses for the nine months ended September 30, 2007 were \$19.4 million, representing an increase of \$4.3 million or 28.1%, as compared to general and administrative expenses of \$15.1 million for the nine months ended September 30, 2006. This increase was primarily attributable to increases in costs related to being a public company, an increase in bonus expense due to a higher expected payout in 2007 than in 2006, an increase in legal costs, and an increase in bad debt expense related to the increase in revenue. Our year to date legal costs have increased, in part, due to increased pre-trial activity in on-going litigation initiated by a former learner, which litigation includes both his claims against us and our counterclaims against him. This litigation against us, alleging inadequate access to our courserooms under federal and state disability laws, is scheduled for trial in November 2007, as is an appeal on our counterclaim for defamation and interference with business relations. Our general and administrative expenses as a percentage of revenues increased by 0.2 percentage points to 11.9% for the nine months ended September 30, 2007, from 11.7% for the nine months ended September 30, 2006 due to increased public company and legal expenses, partially offset by a decrease in the use of external contractors and training expenses related to our enterprise resource planning system.

Other income, net. Other income, net increased by \$0.4 million, or 12.4%, to \$3.5 million for the nine months ended September 30, 2007, from \$3.1 million for the nine months ended September 30, 2006. The increase was primarily due to increased levels of interest income on higher average cash and marketable securities balances, partially offset by lower levels of interest income from the higher proportion of tax-exempt investments in the nine months of 2007.

Income tax expense. We recognized tax expense for the nine months ended September 30, 2007 and 2006 of \$7.1 million and \$5.5 million, respectively, or at effective tax rates of 34.1% and 41.6%, respectively. The decrease in our effective tax rate in 2007 from 2006 was primarily due to the increased use of tax-exempt investments, a decrease in the impact of non-deductible FAS 123(R) stock-based compensation expense for incentive stock options and a decrease in the amount of non-deductible meals and entertainment expenses.

Net income. Net income was \$13.7 million for the nine months ended September 30, 2007, compared to net income of \$7.7 million for the nine months ended September 30, 2006, an increase of \$6.0 million, because of the factors discussed above.

Liquidity and Capital Resources

Liquidity

We financed our operating activities and capital expenditures during the nine months ended September 30, 2007 and 2006 primarily through cash provided by operating activities. Our cash, cash equivalents and marketable securities were \$124.7 million and \$87.7 million at September 30, 2007 and December 31, 2006, respectively.

In August 2004, we entered into an unsecured \$10.0 million line of credit with Wells Fargo Bank. The line of credit has an expiration date of June 30, 2008. There have been no borrowings to date under this line of credit, therefore \$10.0 million is available. Any borrowings would bear interest at a rate of either LIBOR plus 2.5% or the bank's prime rate, at our discretion on the borrowing date.

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A significant portion of our revenues are derived from Title IV programs. Federal regulations dictate the timing of disbursements under Title IV programs. Learners must apply for new loans and grants each academic year, which starts July 1. Loan funds are generally provided by lenders in multiple disbursements for each academic year.

The disbursements are usually received by the start of the second week of the term. These factors, together with the timing of our learners beginning their programs, affect our operating cash flow.

Based on our current level of operations and anticipated growth, we believe that our cash flow from operations and other sources of liquidity, including cash, cash equivalents and marketable securities, will provide adequate funds for ongoing operations and planned capital expenditures for the foreseeable future.

Operating Activities

Net cash provided by operating activities was \$27.7 million and \$18.5 million for the nine months ended September 30, 2007 and 2006, respectively. The increase from 2006 to 2007 was primarily due to the \$6.0 million increase in net income; the \$5.1 million increase in accounts payable and accrued liabilities related to the timing of vendor payments; and the \$1.8 million increase in depreciation and bad debt expense. This was offset by the \$3.6 million decrease in income taxes payable related primarily to excess tax benefits from stock-based compensation due to an increase in stock option exercises in the nine months ended September 30, 2007 over the same period in 2006, as well as our lower effective tax rate and higher tax payments in 2007.

Investing Activities

Our cash used in investing activities is primarily related to the purchase of property and equipment and investments in marketable securities. Net cash used in investing activities was \$32.2 million and \$23.2 million for the nine months ended September 30, 2007 and 2006, respectively. Investments in marketable securities consists of purchases and sales of auction rate, asset-backed, U.S. agency and corporate debt securities, tax-exempt municipals, repurchase agreements and money market funds.

Net purchases of these securities were \$18.1 million and \$12.1 million during the nine months ended September 30, 2007 and 2006, respectively. Capital expenditures were \$14.1 million and \$11.1 million for the nine months ended September 30, 2007 and 2006, respectively. The increase in 2007 from 2006 was primarily due to the implementation of additional modules of our enterprise resource planning system and the development of our new online visitor center website.

We expect to continue to invest in integrating most of our business systems with an enterprise resource planning system. We expect that once implemented, this integration of our systems and processes will improve efficiencies within our instructional costs and services, marketing and promotional and general and administrative expenses. We expect that our capital expenditures in 2007 will be approximately \$16.0 million to \$16.5 million. We expect to be able to fund these capital expenditures with cash generated from operations.

We lease all of our facilities. We expect to make future payments on existing leases from cash generated from operations.

Financing Activities

Net cash provided by financing activities was \$23.4 million for the nine months ended September 30, 2007, and net cash used in financing activities was \$2.3 million for the nine months ended September 30, 2006. Financing activities during the nine months ended September 30, 2007 were primarily related to proceeds of \$10.9 million from the issuance of common stock in our May 2007 follow-on offering, \$8.5 million in proceeds from stock option exercises and \$3.9 million in excess tax benefits due to an increase in stock option exercises in the nine months ended September 30, 2007 over the same period in 2006. Financing activities during the nine months ended September 30, 2006 were primarily related to payments on notes payable used to finance asset purchases related to our enterprise resource planning system of \$2.2 million.

Regulatory Supervision and Oversight

We perform periodic reviews of our compliance with the various applicable regulatory requirements. We have not been notified by any of the various regulatory agencies of any significant noncompliance matters that would adversely impact our ability to participate in Title IV programs, however, the Office of Inspector General (the OIG) of the Department of Education has conducted a compliance audit of Capella University. The OIG is responsible for, among other things, promoting the effectiveness and integrity of the Department of Education's programs and operations. The audit commenced on April 10, 2006 and we subsequently provided

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the OIG with periodic information, responded to follow up inquiries and facilitated site visits and access to our records. The OIG informed us that it completed its field work in January 2007 and we received a draft audit report on August 23, 2007. The draft audit report is preliminary, and is subject to further review and revision by the OIG. We provided written comments on the draft audit report to the OIG on September 25, 2007. At some time in the future, the OIG's final report will be issued to the Acting Chief Operating Officer for Federal Student Aid, who will subsequently issue final findings and requirements for the University. The most significant potential financial exposure from the audit pertains to repayments to the Department of Education that could be required if the OIG concludes that we did not properly calculate the amount of Title IV funds required to be returned for learners that withdrew from Capella University without providing an official notification of such withdrawal and without engaging in academic activity prior to such withdrawal. If it is determined that we improperly withheld any portion of these funds, we would be required to return the improperly withheld funds. For the three year audit period, and for the 2005-2006 aid year, we estimate that the total amount of Title IV funds not returned for learners who withdrew without providing official notification was less than \$1.0 million, including interest, but not including fines and penalties.

In addition to the DOE and state higher education regulatory bodies, other governmental entities exercise oversight authority over our business practices. In April 2007, we received inquiries from the New York and Minnesota Attorneys General in connection with their ongoing reviews of financial aid practices at various colleges and universities. As part of its inquiry, the New York Attorney General requested information regarding the relationship between Student Loan Express, one of 15 institutions currently listed by us as a recommended student lender, and Timothy Lehmann, our former Director of Financial Aid.

On May 15, 2007, we announced settlements with the attorneys general of New York and Minnesota. In connection with these settlements, we have adopted a code of conduct recently established by the New York Attorney General, which is similar to our existing financial aid practices. We did not pay any fines or restitution in connection with these settlements.

On April 19, 2007, we received a letter of inquiry from U.S. Senator Edward Kennedy, Chairman of the Senate Health, Education, Labor and Pensions Committee (HELP Committee), related to the Committee's oversight of the federally-guaranteed student loan program. We have responded to this inquiry, which appeared to focus on similar issues to those raised by the New York Attorney General. On September 14, 2007, the HELP Committee released its "Report on Marketing Practices in the Federal Family Education Loan Program." While the Committee's inquiry into Capella has not officially concluded, we have received no further requests for information or to appear before the Committee.

On May 21, 2007, we received a letter of inquiry from the OIG. This inquiry focused on similar issues to those raised by the Attorneys General and Senator Kennedy's committee, and we met with OIG personnel in July 2007 and provided documentation to the OIG to respond to their inquiry. We have received no further requests for information regarding this inquiry from the OIG since our initial response and meeting.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Market Risk

We have no derivative financial instruments or derivative commodity instruments. We believe the risk related to marketable securities is limited due to the adherence to our investment policy that requires marketable securities to have a minimum Standard & Poor's rating of A minus (or equivalent). All of our marketable securities as of September 30, 2007 and December 31, 2006 consisted of cash equivalents and marketable securities rated A minus or higher.

Interest Rate Risk

We manage interest rate risk by investing excess funds in cash equivalents and marketable securities bearing variable interest rates, which are tied to various market indices. Our future investment income may fall short of expectations due to changes in interest rates or we may suffer losses in principal if we are forced to sell securities that have declined in market value due to changes in interest rates. At September 30, 2007, a 10% increase or decrease in interest rates would not have a material impact on our future earnings, fair values, or cash flows related to investments in cash equivalents or interest earning marketable securities.

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Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

We carried out an evaluation, under the supervision and with the participation of our management, including the chief executive officer and the chief financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15 (e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the “Exchange Act”). Based upon that evaluation, our chief executive officer and chief financial officer concluded that the company’s disclosure controls and procedures are effective, as of September 30, 2007, in ensuring that material information relating to us required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in reports it files or submits under the Securities Exchange Act is accumulated and communicated to management, including its principal executive officer or officers and principal financial officer or officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

Changes in internal control over financial reporting.

There was no change in our internal control over financial reporting identified in connection with the evaluation required by Rule 13a-15 (d) and 15d-15(d) of the Exchange Act that occurred during the period covered by this report that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II – OTHER INFORMATION

Item 1. Legal Proceedings

From time to time, we are a party to various lawsuits, claims and other legal proceedings that arise in the ordinary course of our business. We are not at this time a party, as plaintiff or defendant, to any legal proceedings which, individually or in the aggregate, would be expected to have a material adverse effect on our business, financial condition or results of operation.

Item 1A. Risk Factors

There have been no material changes to the risk factors disclosed in the “Risk Factors” section of our Annual Report on Form 10-K for the year ended December 31, 2006, as updated in our Quarterly Report on Form 10-Q for the quarter ended March 31, 2007.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Recent Sales of Unregistered Securities

None.

Purchases of Equity Securities by the Issuer and Affiliated Purchasers

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Submission of Matters to a Vote of Security Holders

None.

Item 5. Other Information

None.

Item 6. Exhibits

(a) Exhibits

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Number	Description	Method of Filing
3.1	Amended and Restated Articles of Incorporation.	Incorporated by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K filed with the SEC on November 11, 2006.
3.2	Amended and Restated By-Laws.	Incorporated by reference to Exhibit 3.4 to Amendment No. 3 to the Company's Registration Statement on Form S-1 filed with the SEC on October 6, 2006.
4.1	Specimen of common stock certificate.	Incorporated by reference to Exhibit 4.1 to Amendment No. 4 to the Company's Registration Statement on Form S-1 filed with the SEC on October 19, 2006.
10.1	Form of Restricted Stock Agreement for the Capella Education Company 2005 Stock Incentive Plan.	Filed electronically.
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.	Filed electronically.
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.	Filed electronically.
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.	Filed electronically.
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.	Filed electronically.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

CAPELLA EDUCATION COMPANY

<u>/s/ S TEPHEN G. S HANK</u> Stephen G. Shank Chairman and Chief Executive Officer (Principal Executive Officer)	November 1, 2007
<u>/s/ L OIS M. M ARTIN</u> Lois M. Martin Senior Vice President and Chief Financial Officer (Principal Financial Officer)	November 1, 2007
<u>/s/ A MY L. D RIFKA</u> Amy L. Drifka Vice President and Controller (Principal Accounting Officer)	November 1, 2007

**CAPELLA EDUCATION COMPANY
2005 STOCK INCENTIVE PLAN**

**Restricted Stock Agreement
(Employee)**

Name of Recipient:	
No. of Shares Covered:	Grant Date:
Vesting Schedule (Cumulative): <div style="display: flex; justify-content: space-between; margin-top: 20px;"> <u>Vesting Date(s)</u> <u>Number of Shares That Vest</u> </div>	

This is a Restricted Stock Agreement (“Agreement”) between Capella Education Company, a Minnesota corporation (the “Company”), and the recipient identified above (the “Recipient”) effective as of the date of grant specified above. To the extent any capitalized terms used in this Agreement are not defined, they shall have the meaning ascribed to them in the Company’s 2005 Stock Incentive Plan (the “Plan”).

Recitals

WHEREAS, the Company maintains the Plan; and

WHEREAS, pursuant to the Plan, the Board of Directors of the Company (the “Board”) or a committee of two or more directors of the Company (the “Committee”) designated by the Board administers the Plan and has the authority to determine the awards to be granted under the Plan (if the Board has not appointed a committee to administer the Plan, then the Board shall constitute the Committee); and

WHEREAS, the Committee has determined that the Recipient is eligible to receive an award under the Plan in the form of shares of restricted stock;

NOW, THEREFORE, the Company hereby grants this award to the Recipient under the terms and conditions as follows.

Terms and Conditions

1. Grant of Restricted Stock .

(a) Subject to the terms and conditions of this Agreement, the Company has issued to the Recipient the number of Shares specified at the beginning of this Agreement. These Shares are subject to the restrictions provided for in this Agreement and are referred to collectively as the “Restricted Shares” and each as a “Restricted Share.”

(b) The Restricted Shares will be evidenced by a book entry made in the records of the Company’s transfer agent in the name of the Recipient (unless the Recipient requests a certificate evidencing the Restricted Shares). All restrictions provided for in this Agreement will apply to each Restricted Share and to any other securities distributed with respect to that Restricted Share. Each Restricted Share will remain restricted and subject to forfeiture to the Company unless and until that Restricted Share has vested in the Recipient in accordance with all of the terms and conditions of this Agreement. If a certificate evidencing any Restricted Share is requested by the Recipient, the Company shall retain custody of any such certificate throughout the period during which any restrictions are in effect and require, as a condition to issuing any such certificate, that the Recipient tender to the Company a stock power duly executed in blank relating to such custody.

2. **Vesting .** The Restricted Shares that have not previously been forfeited will vest in the numbers and on the dates specified in the Vesting Schedule at the beginning of this Agreement, subject to the following provisions:

Death or Disability. The Restricted Shares that have not previously vested or been forfeited will, upon the termination of the Recipient’s employment due to death or Disability, vest as to a prorated portion of such Restricted Shares based on the portion of the term until such Restricted Shares vest during which the Recipient was employed by the Company, and, with respect to any such shares, all restrictions shall lapse.

Change in Control . If a Change in Control (as defined in Section 3 of this Agreement) of the Company shall occur and within three years of such Change in Control, (i) Recipient’s employment with the Company shall be terminated other than for Cause (as defined in the Plan), or (ii) Recipient shall voluntarily leave employment with the Company for Good Reason (as defined below), then, upon the date of such termination or voluntary leaving of employment for Good Reason, the restrictions applicable to any Restricted Shares shall lapse and the Restricted Shares shall become fully vested. For purposes of this Agreement, “Good Reason” is defined as the demotion or reduction of the job responsibilities of Recipient or the reassignment, without Recipient’s consent, of Recipient’s place of work to a location more than 50 miles from the Recipient’s place of work immediately prior to the Change in Control.

Discretionary Acceleration. The Committee has the power, in its sole discretion, to declare at any time that the Restricted Shares subject to this award shall vest.

3. **Change in Control Definition**. For purposes of this Plan, a “Change in Control” of the Company shall be deemed to occur if any of the following occur:

(a) Any “person” (as such term is used in Sections 13(d) and 14(d) of the Exchange Act) acquires or becomes a “beneficial owner” (as defined in Rule 13d-3 or any successor rule under the Exchange Act), directly or indirectly, of securities of the Company representing the 65% or more of the combined voting power of the Company’s then outstanding securities entitled to vote generally in the election of directors (“Voting Securities”). Provided, however, that the following shall not constitute a Change in Control pursuant to this Section 3 (a):

(1) any acquisition or beneficial ownership by the Company or a subsidiary;

(2) any acquisition or beneficial ownership by any employee benefit plan (or related trust) sponsored or maintained by the Company or one or more of its subsidiaries;

(3) any acquisition or beneficial ownership by any corporation with respect to which, immediately following such acquisition, more than 65% of both the combined voting power of the Company’s then outstanding Voting Securities and the Shares of the Company is then beneficially owned, directly or indirectly, by all or substantially all of the persons who beneficially owned Voting Securities and Shares of the Company immediately prior to such acquisition in substantially the same proportions as their ownership of such Voting Securities and Shares, as the case may be, immediately prior to such acquisition;

(b) A majority of the members of the Board of Directors of the Company shall not be Continuing Directors. “Continuing Directors” shall mean: (1) individuals who, on the date hereof, are directors of the Company, (2) individuals elected as directors of the Company subsequent to the date hereof for whose election proxies shall have been solicited by the Board of Directors of the Company or (3) any individual elected or appointed by the Board of Directors of the Company to fill vacancies on the Board of Directors of the Company caused by death or resignation (but not by removal) or to fill newly-created directorships;

(c) Consummation by the Company of a reorganization, merger or consolidation of the Company or a statutory exchange of outstanding Voting Securities of the Company, unless, immediately following such reorganization, merger, consolidation or exchange, all or substantially all of the persons who were the beneficial owners, respectively, of Voting Securities and Shares of the Company immediately prior to such reorganization, merger, consolidation or exchange beneficially own, directly or indirectly, more than 65% of, respectively, the combined voting power of the then outstanding voting securities entitled to vote generally in the election of directors and the then outstanding shares of common stock, as the case may be, of the corporation resulting from such reorganization, merger, consolidation or exchange in substantially the same proportions as their ownership, immediately prior to such reorganization, merger, consolidation or exchange, of the Voting Securities and Shares of the Company, as the case may be;

(d) Consummation by the Company of the sale or other disposition of all or substantially all of the assets of the Company (in one or a series of transactions), other than to a corporation with respect to which, immediately following such sale or other disposition, more than 65% of, respectively, the combined voting power of the then outstanding voting securities of such corporation entitled to vote generally in the election of directors and the then outstanding shares of common stock of such corporation is then beneficially owned, directly or indirectly, by all or substantially all of the persons who were the beneficial owners, respectively, of the Voting Securities and Shares of the Company immediately prior to such sale or other disposition in substantially the same proportions as their ownership, immediately prior to such sale or other disposition, of the Voting Securities and Shares of the Company, as the case may be; or

(e) Approval by the shareholders of the Company of a complete liquidation or dissolution of the Company.

4. **Lapse of Restrictions; Issuance of Unrestricted Shares** . Upon the vesting of any Restricted Shares, such vested Restricted Shares will no longer be subject to forfeiture as provided in Section 5 of this Agreement. Upon the vesting of any Restricted Shares, all restrictions on such Restricted Shares will lapse, and the Company will, subject to the provisions of the Plan, issue to the Recipient a certificate evidencing the Restricted Shares that is free of any transfer or other restrictions arising under this Agreement.

5. **Forfeiture** . If (i) the Recipient's employment with the Company is terminated for any reason, whether by the Company, by the Recipient or otherwise, voluntarily or involuntarily, other than in the circumstances described in Section 2 of this Agreement, or (ii) the Recipient attempts to sell, assign, transfer or otherwise dispose of, or mortgage, pledge or otherwise encumber any of the Restricted Shares or the Restricted Shares become subject to attachment or any similar involuntary process, then any Restricted Shares that have not previously vested shall be forfeited by the Recipient to the Company, the Recipient shall thereafter have no right, title or interest whatever in such Restricted Shares, and, if the Company does not have custody of any and all certificates representing Restricted Shares so forfeited, the Recipient shall immediately return to the Company any and all certificates representing Restricted Shares so forfeited. Additionally, the Recipient will deliver to the Company a stock power duly executed in blank relating to any and all certificates representing Restricted Shares forfeited to the Company in accordance with the previous sentence or, if such stock power has previously been tendered to the Company, the Company will be authorized to deem such previously tendered stock power delivered, and the Company will be authorized to cancel any and all certificates representing Restricted Shares so forfeited and to cause a book entry to be made in the records of the Company's transfer agent in the name of the Recipient (or a new stock certificate to be issued, if requested by the Recipient) evidencing any Shares that vested prior to forfeiture. If the Restricted Shares are evidenced by a book entry made in the records of the Company's transfer agent, then the Company will be authorized to cause such book entry to be adjusted to reflect the number of Restricted Shares so forfeited.

6. **Shareholder Rights** . As of the date of grant specified at the beginning of this Agreement, the Recipient shall have all of the rights of a shareholder of the Company with respect to the Restricted Shares (including voting rights and the right to receive dividends and other distributions), except as otherwise specifically provided in this Agreement.

7. **Restrictive Legends and Stop-Transfer Orders** .

(a) The book entry or certificate representing the Restricted Shares shall contain a notation or bear the following legend (as well as any notations or legends required by applicable state and federal corporate and securities laws) noting the existence of the restrictions and the Company's rights to reacquire the Restricted Shares set forth in this Agreement:

“THE SHARES REPRESENTED BY THIS [BOOK ENTRY] [CERTIFICATE] MAY BE TRANSFERRED ONLY IN ACCORDANCE WITH THE TERMS OF A RESTRICTED STOCK AGREEMENT BETWEEN THE COMPANY AND THE SHAREHOLDER, A COPY OF WHICH IS ON FILE WITH THE SECRETARY OF THE COMPANY.”

(b) The Recipient agrees that, in order to ensure compliance with the restrictions referred to herein, the Company may issue appropriate “stop transfer” instructions to its transfer agent, if any, and that, if the Company transfers its own securities, it may make appropriate notations to the same effect in its own records.

(c) The Company shall not be required (i) to transfer on its books any Restricted Shares that have been sold or otherwise transferred in violation of any of the provisions of this Agreement, or (ii) to treat as owner of the Restricted Shares or to accord the right to vote or pay dividends to any purchaser or other transferee to whom the Restricted Shares shall have been so transferred.

8. **Tax Consequences and Withholdings** . The Recipient understands that unless a proper and timely Section 83(b) election has been made as further described below, generally under Section 83 of the Code, at the time the Restricted Shares vest, the Recipient will recognize ordinary income equal to the Fair Market Value of the Restricted Shares then vesting. The Recipient shall be solely responsible for tax obligations that arise as a result of the vesting or sale of the Restricted Shares. When the Recipient recognizes income upon vesting of the Restricted Shares, or upon filing a Section 83(b) election as described below, the Company shall have the right to require the payment (through withholding from the Recipient's salary or otherwise) of any federal, state, local or foreign taxes based on the Fair Market Value of the Restricted Shares then vesting (or, in the case of an election under Section 83(b), as of the date of issuance).

9. **Section 83(b) Election** . The Recipient has been informed that, with respect to the grant of Restricted Shares, an election may be filed by the Recipient with the Internal Revenue Service, within 30 days of the date of issuance, electing pursuant to Section 83(b) of the Code to be taxed

upon making such election on the Fair Market Value of the Restricted Shares on the date of issuance. The Recipient acknowledges that it is the Recipient's sole responsibility to timely file the election under Section 83(b) of the Code if the Recipient chooses to make such an election. The Recipient has been advised that he or she should consult his or her personal tax or financial advisor with any questions regarding whether to make a Section 83(b) election. If the Recipient makes such election, the Recipient shall promptly provide the Company a copy of the election form.

10. Forfeiture Events .

(a) The Recipient, by accepting this award, agrees and covenants that during the period during which the Recipient is employed by the Company and twelve months following the date of termination of the Recipient's employment by the Company (the "Restricted Period") for any reason whatsoever, the Recipient will not, directly or indirectly:

- (1) perform services for any Competitive Business as employee, consultant, contractor or otherwise;
- (2) solicit or attempt to solicit any employee or independent contractor of the Company to cease working for the Company;
- (3) use or disclose to any person any Confidential Information for any purpose;
- (4) take any action that might divert any opportunity from the Company or any of its affiliates, successors or assigns (the "Related Parties") that is within the scope of the present or future operations or business of any Related Parties;
- (5) contact, call upon or solicit any customer of the Company, or attempt to divert or take away from the Company the business of any of its customers;
- (6) contact, call upon or solicit any prospective customer of the Company that the Recipient became aware of or were introduced to in the course of the Recipient's duties for the Company, or otherwise divert or take away from the Company the business of any prospective customer of the Company; or
- (7) engage in any activity that is harmful to the interests of the Company, including, without limitation, any conduct during the term of the Recipient's employment that violates the Company's codes of conduct or other policies.

(b) If the Company determines that the Recipient violated any provisions of Section 9(a) above during the Restricted Period, the Recipient agrees and covenants that:

- (1) any of the Restricted Shares that have not vested as of the date of such determination shall be immediately forfeited; and

(2) the Recipient shall automatically forfeit any rights the Recipient may have with respect to the Restricted Shares as of the date of such determination.

(c) The foregoing remedies set forth in Section 10(b) shall not be the Company's exclusive remedies. The Company reserves all other rights and remedies available to it at law or in equity.

(d) The Company may exercise its right to demand forfeiture within ninety days after discovery of such an occurrence but in no event later than fifteen months after the Recipient's termination of employment with the Company.

(e) For purposes of this Section 10, the following terms shall have the meanings set forth below:

"Competitive Business" shall mean any person, corporation, not-for-profit organization, or other entity that provides, develops, sells, or markets on-line credit-granting educational products or services in any country in which the Company did business or had customers at any time during the last 12 months of the Recipient's employment with the Company. In the case of an organization that provides, develops, sells, or markets on-line credit-granting educational products or services within or from a distinct, separate division or unit of the organization (the "On-Line Unit") and also provides, develops, sells, or markets credit-granting educational products or services through other means within other distinct, separate divisions or units, the term "Competitive Business" shall be limited to the On-Line Unit, and shall not apply to the organization as a whole.

"Confidential Information" means information proprietary to the Company and not generally known (including trade secret information) about the Company's customers, products, services, personnel, pricing, sales strategy, technology, methods, processes, research, development, finances, systems, techniques, accounting, purchasing, and business strategies. All information disclosed to the Recipient or to which the Recipient obtains access, whether originated by the Recipient or by others, during the period of the Recipient's employment, shall be presumed to be Confidential Information if it is treated by the Company as being Confidential Information or if the Recipient has a reasonable basis to believe it to be Confidential Information.

11. Discontinuance of Employment . This Agreement shall not give the Recipient a right to continued employment with the Company or any parent or subsidiary of the Company, and the Company or any such parent or subsidiary employing the Recipient may terminate his/her employment at any time and otherwise deal with the Recipient without regard to the effect it may have upon him/her under this Agreement.

12. Interpretation of This Agreement . All decisions and interpretations made by the Committee with regard to any question arising hereunder or under the Plan shall be binding and conclusive upon the Company and the Recipient. If there is any inconsistency between the provisions of this Agreement and the Plan, the provisions of the Plan shall govern.

13. **Award Subject to Plan, Articles of Incorporation and By-Laws** . The Recipient acknowledges that the Restricted Shares are subject to the Plan, the Articles of Incorporation, as amended from time to time, and the By-Laws, as amended from time to time, of the Company, and any applicable federal or state laws, rules or regulations.

14. **Binding Effect** . This Agreement shall be binding in all respects on the heirs, representatives, successors and assigns of the Recipient.

15. **Choice of Law** . This Agreement is entered into under the laws of the State of Minnesota and shall be construed and interpreted thereunder (without regard to its conflict of law principles).

IN WITNESS WHEREOF, the Recipient and the Company have executed this Agreement as of the ____day of _____, 20 ____.

RECIPIENT

CAPELLA EDUCATION COMPANY

By _____

Its _____

**CERTIFICATION PURSUANT TO
SECTION 302 OF
THE SARBANES-OXLEY ACT OF 2002**

CERTIFICATION OF CHIEF EXECUTIVE OFFICER

I, Stephen G. Shank, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Capella Education Company;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a) All significant deficiencies and material weaknesses in the design or operation of internal controls over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 1, 2007

/s/ Stephen G. Shank

Stephen G. Shank

Chairman and Chief Executive Officer

**CERTIFICATION PURSUANT TO
SECTION 302 OF
THE SARBANES-OXLEY ACT OF 2002**

CERTIFICATION OF CHIEF FINANCIAL OFFICER

I, Lois M. Martin, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Capella Education Company;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a) All significant deficiencies and material weaknesses in the design or operation of internal controls over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 1, 2007

/s/ Lois M. Martin

Lois M. Martin

Senior Vice President and Chief Financial Officer

**Certification of Principal Executive Officer
Pursuant to 18 U.S.C. 1350
(Section 906 of the Sarbanes-Oxley Act of 2002)**

In connection with the Quarterly Report of Capella Education Company (the "Company") on Form 10-Q for the quarter ended September 30, 2007 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Stephen G. Shank, Chairman and Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. §1350, as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Stephen G. Shank

Stephen G. Shank
Chairman and Chief Executive Officer
November 1, 2007

This certification accompanies this Report pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and shall not be deemed to be incorporated by reference into any filing under the Securities Act of 1933, as amended, or the Exchange Act, except to the extent that the Company specifically incorporates it by reference.

A signed original of this written statement required by Section 906 has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.

**Certification of Principal Financial Officer
Pursuant to 18 U.S.C. 1350
(Section 906 of the Sarbanes-Oxley Act of 2002)**

In connection with the Quarterly Report of Capella Education Company (the "Company") on Form 10-Q for the quarter ended September 30, 2007 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Lois M. Martin, Senior Vice President and Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. §1350, as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Lois M. Martin

Lois M. Martin

Senior Vice President and Chief Financial Officer

November 1, 2007

This certification accompanies this Report pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and shall not be deemed to be incorporated by reference into any filing under the Securities Act of 1933, as amended, or the Exchange Act, except to the extent that the Company specifically incorporates it by reference.

A signed original of this written statement required by Section 906 has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.