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CAPELLA EDUCATION CO

FORM 10-Q
(Quarterly Report)

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Table of Contents

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2013

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.)**
Capella Tower **225 South Sixth Street, 9th Floor** **Minneapolis, Minnesota** **(Address of principal executive offices)**	**55402** **(Zip Code)**

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☒ No ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer	☐	Accelerated filer	☒
Non-accelerated filer	☐ (Do not check if a smaller reporting company)	Smaller reporting company	☐

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

The total number of shares of common stock outstanding as of July 18, 2013 was 12,392,860 .

CAPELLA EDUCATION COMPANY

FORM 10-Q
INDEX

		Page
	PART I – FINANCIAL INFORMATION	
Item 1	Financial Statements	3
Item 2	Management's Discussion and Analysis of Financial Condition and Results of Operations	14
Item 3	Quantitative and Qualitative Disclosures About Market Risk	22
Item 4	Controls and Procedures	24
	PART II – OTHER INFORMATION	
Item 1	Legal Proceedings	25
Item 1A	Risk Factors	25
Item 2	Unregistered Sales of Equity Securities and Use of Proceeds	25
Item 3	Defaults Upon Senior Securities	25
Item 4	Mine Safety Disclosures	25
Item 5	Other Information	25
Item 6	Exhibits	26
SIGNATURES		27

PART I – FINANCIAL INFORMATION

Item 1. Financial Statements

CAPELLA EDUCATION COMPANY

Consolidated Balance Sheets
(In thousands, except par value)

	As of June 30, 2013	As of December 31, 2012
	(Unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 107,581	$ 93,220
Marketable securities	37,228	22,279
Accounts receivable, net of allowance of $5,923 at June 30, 2013 and $6,231 at December 31, 2012	14,861	15,900
Prepaid expenses and other current assets	11,688	11,124
Deferred income taxes	3,486	3,481
Total current assets	174,844	146,004
Property and equipment, net	42,269	45,240
Goodwill	16,885	16,970
Intangibles, net	3,734	4,674
Total assets	$ 237,732	$ 212,888
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 6,562	$ 5,798
Accrued liabilities	35,714	26,392
Deferred revenue	9,451	9,651
Total current liabilities	51,727	41,841
Deferred rent	3,437	4,150
Other liabilities	2,190	6,425
Deferred income taxes	8,344	8,370
Total liabilities	65,698	60,786
Shareholders' equity:		
Common stock, $0.01 par value: Authorized shares — 100,000; Issued and Outstanding shares — 12,393 at June 30, 2013 and December 31, 2012	124	124
Additional paid-in capital	100,005	97,716
Accumulated other comprehensive income (loss)	145	(22)
Retained earnings	71,760	54,284
Total shareholders' equity	172,034	152,102
Total liabilities and shareholders' equity	$ 237,732	$ 212,888

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

CAPELLA EDUCATION COMPANY

Consolidated Statements of Income
(In thousands, except per share amounts)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
	(Unaudited)			
Revenues	$ 103,693	$ 106,180	$ 208,935	$ 215,580
Costs and expenses:				
Instructional costs and services	44,900	46,704	91,867	95,137
Marketing and promotional	24,101	25,437	49,602	50,859
Admissions advisory	6,727	7,482	13,498	15,170
General and administrative	10,500	8,501	21,328	18,421
Total costs and expenses	86,228	88,124	176,295	179,587
Operating income	17,465	18,056	32,640	35,993
Other income (expense), net	(25)	60	(225)	17
Income before income taxes	17,440	18,116	32,415	36,010
Income tax expense	7,018	6,704	13,238	13,491
Net income	10,422	11,412	19,177	22,519
Net loss attributable to noncontrolling interest	—	—	—	186
Net income attributable to Capella Education Company	$ 10,422	$ 11,412	$ 19,177	$ 22,705
Net income attributable to Capella Education Company per common share:				
Basic	$ 0.84	$ 0.85	$ 1.55	$ 1.68
Diluted	$ 0.83	$ 0.85	$ 1.54	$ 1.67
Weighted average number of common shares outstanding:				
Basic	12,394	13,369	12,394	13,541
Diluted	12,498	13,425	12,489	13,604

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

CAPELLA EDUCATION COMPANY

Consolidated Statements of Comprehensive Income
(In thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
	(Unaudited)			
Net income	$ 10,422	$ 11,412	$ 19,177	$ 22,519
Net loss attributable to noncontrolling interest	—	—	—	186
Net income attributable to Capella Education Company	10,422	11,412	$ 19,177	$ 22,705
Other comprehensive income (loss):				
Foreign currency translation gain (loss)	77	(91)	188	(81)
Unrealized gains (losses) on available for sale securities, net of tax	(24)	(90)	(21)	(191)
Comprehensive income attributable to Capella Education Company	$ 10,475	$ 11,231	$ 19,344	$ 22,433

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

CAPELLA EDUCATION COMPANY

Consolidated Statements of Cash Flows
(In thousands)

	Six Months Ended June 30,	
	2013	2012
	(Unaudited)	
Operating activities		
Net income	$ 19,177	$ 22,519
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for bad debts	7,060	7,043
Depreciation and amortization	13,596	14,403
Amortization of investment discount/premium	308	475
Impairment of property and equipment	229	956
Loss on disposal of property and equipment	39	77
Share-based compensation	2,606	1,933
Excess tax benefits from share-based compensation	(66)	(37)
Deferred income taxes	(43)	(1,631)
Changes in operating assets and liabilities:		
Accounts receivable	(6,044)	(5,154)
Prepaid expenses and other current assets	820	(54)
Accounts payable and accrued liabilities	6,189	(3,109)
Income tax payable	(1,486)	(2,766)
Deferred rent	(713)	(95)
Deferred revenue	(116)	1,069
Net cash provided by operating activities	41,556	35,629
Investing activities		
Capital expenditures	(10,310)	(11,697)
Proceeds from the sale of property and equipment	—	303
Redemption of noncontrolling interest	—	(1,576)
Purchases of marketable securities	(22,426)	—
Sales and maturities of marketable securities	7,135	32,035
Net cash provided by (used in) investing activities	(25,601)	19,065
Financing activities		
Excess tax benefits from share-based compensation	66	37
Net proceeds from exercise of stock options	524	244
Repurchases of common stock	(2,137)	(25,483)
Net cash used in financing activities	(1,547)	(25,202)
Effect of foreign exchange rates on cash	(47)	(6)
Net increase in cash and cash equivalents	14,361	29,486
Cash and cash equivalents at beginning of period	93,220	61,977
Cash and cash equivalents at end of period	$ 107,581	$ 91,463
Supplemental disclosures of cash flow information		
Income taxes paid	$ 14,770	$ 18,014
Noncash transactions:		
Purchase of equipment included in accounts payable and accrued liabilities	$ 207	$ 438

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

CAPELLA EDUCATION COMPANY

Notes to Consolidated Financial Statements
(Unaudited)

1. Nature of Business

Capella Education Company (the Company) was incorporated on December 27, 1991, and is the parent company of its wholly owned subsidiaries, Capella University (the University), Resource Development International Limited (RDI), and Sophia Learning, LLC (Sophia). The University, founded in 1993, is an online postsecondary education services company offering a variety of bachelor's, master's and doctoral degree programs primarily delivered to working adults. The University is accredited by The Higher Learning Commission and is a member of the North Central Association of Colleges and Schools. In 2011, the Company acquired RDI, which is an independent provider of United Kingdom (UK) university distance learning qualifications that markets, develops and delivers programs worldwide via its offices and partners across Asia, North America, Africa and Europe. Sophia provides a social teaching and learning platform that integrates education with technology. On April 16, 2012 , the Company acquired the remaining interest in Sophia which is now a wholly owned subsidiary as of that date. With the Company's focus on academic quality in an online delivery format, it has one reporting segment.

2. Summary of Significant Accounting Policies

Consolidation

The consolidated financial statements include the accounts of the Company, the University, RDI and its subsidiaries, and Sophia, after elimination of intercompany accounts and transactions. RDI operates on a fiscal year ending October 31, which is also the date used for consolidation.

Unaudited Interim Financial Information

The accompanying unaudited consolidated financial statements of the Company have been prepared in accordance with accounting principles generally accepted in the United States (GAAP) for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, these statements include all adjustments (consisting of normal recurring adjustments) considered necessary to present a fair statement of the Company's consolidated results of operations, financial position and cash flows. Operating results for any interim period are not necessarily indicative of the results that may be expected for the full year. Preparation of the Company’s financial statements in conformity with GAAP 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, 2012 (2012 Annual Report on Form 10-K).

Share-Based Compensation

The Company measures and recognizes compensation expense for share-based payment awards made to employees and directors, including employee stock options, restricted stock, and market stock units (MSUs) based on estimated fair values of the share award on the date of grant.

To calculate the estimated fair value of stock options on the date of grant, the Company uses the Black-Scholes option pricing model. The Black-Scholes option pricing model requires the Company to estimate key assumptions such as the expected term, volatility, risk-free interest rate and dividend yield to determine the fair value of stock options, based on both historical information and management judgment regarding market factors and trends.

The Company recognizes share-based compensation expense for stock options and restricted stock unit awards using the straight-line method, over the period that the awards are expected to vest, which is also the service period, net of estimated forfeiture rates. The Company estimates expected forfeitures of share-based awards at the grant date and recognizes compensation cost only for those awards expected to vest.

In estimating expected forfeitures for stock options and restricted stock units, the Company analyzes historical forfeiture and termination information and considers how future rates are expected to differ from historical rates. The Company ultimately adjusts this forfeiture assumption to actual forfeitures. Any changes in the forfeiture assumptions do not impact the total amount of expense ultimately recognized over the vesting period. Instead, different forfeiture assumptions only impact the

timing of expense recognition over the vesting period. If the actual forfeitures differ from management estimates, additional adjustments to compensation expense are recorded.

To calculate the estimated fair value of MSUs on the date of grant, the Company uses Monte Carlo simulation. The Monte Carlo simulation is based on the expected 90 day average market price of the Company's common stock prior to the vesting date to estimate the expected number of MSUs that will convert into common shares. Management's key assumptions include volatility, risk-free interest rate, and dividend yield.

The Company recognizes share-based compensation expense for MSU awards using the straight-line method, over the period that the awards are expected to vest. Compensation cost related to an award with a market condition will be recognized regardless of whether the market condition is satisfied, provided that the requisite service has been provided.

Subsequent Events

The Company has reviewed and evaluated events and transactions that occurred subsequent to the balance sheet date. There have been no subsequent events that require recognition or disclosure in the financial statements.

Refer to the Company's "Summary of Significant Accounting Policies" footnote included in its 2012 Annual Report on Form 10-K for a complete summary of the Company's significant accounting policies.

3. Recent Accounting Pronouncements

In February 2013, the FASB issued ASU No. 2013-02, *Reporting of Amounts Reclassified out of Accumulated Other Comprehensive Income*, which is included in ASC 220, *Comprehensive Income* . This update improves the reporting of reclassifications out of accumulated other comprehensive income. The guidance is effective for the Company's interim and annual reporting periods beginning January 1, 2013, and applied prospectively. The adoption of this guidance did not have a material impact on the Company's financial condition, results of operations, or disclosures.

The Company has reviewed and considered all other recent accounting pronouncements and believes there are none that could potentially have a material impact on its financial condition, results of operations, or disclosures.

4. Net Income Attributable to Capella Education Company per Common Share

Basic net income attributable to Capella Education Company per common share is based on the weighted average number of shares of common stock outstanding during the period. Dilutive shares are computed using the Treasury Stock method and include the incremental effect of shares that would be issued upon the assumed exercise of stock options, vesting of restricted stock, and satisfaction of service conditions for market stock units.

The following table presents a reconciliation of the numerator and denominator in the basic and diluted net income attributable to Capella Education Company per common share calculation, in thousands, except per share data:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Numerator:				
Net income attributable to Capella Education Company	$ 10,422	$ 11,412	$ 19,177	$ 22,705
Denominator:				
Denominator for basic net income attributable to Capella Education Company per common share— weighted average shares outstanding	12,394	13,369	12,394	13,541
Effect of dilutive stock options, restricted stock, and market stock units	104	56	95	63
Denominator for diluted net income attributable to Capella Education Company per common share— weighted average shares outstanding	12,498	13,425	12,489	13,604
Basic net income attributable to Capella Education Company per common share	$ 0.84	$ 0.85	$ 1.55	$ 1.68
Diluted net income attributable to Capella Education Company per common share	$ 0.83	$ 0.85	$ 1.54	$ 1.67

Options to purchase 0.7 million and 0.7 million common shares were outstanding, but not included in the computation of diluted net income per common share in the three months ended June 30, 2013 and 2012 , respectively, because their effect would be antidilutive. Options to purchase 0.7 million and 0.6 million common shares were outstanding, but not included in the computation of diluted net income per common share in the six months ended June 30, 2013 and 2012 , respectively, because their effect would be antidilutive.

5. Marketable Securities

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

	As of June 30, 2013			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Estimated Fair Value
Tax-exempt municipal securities	$ 37,246	$ 21	$ (39)	$ 37,228
Total	$ 37,246	$ 21	$ (39)	$ 37,228

	As of December 31, 2012			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Estimated Fair Value
Tax-exempt municipal securities	$ 22,263	$ 25	$ (9)	$ 22,279
Total	$ 22,263	$ 25	$ (9)	$ 22,279

The unrealized gains and losses on the Company’s investments in municipal securities as of June 30, 2013 and December 31, 2012 were caused by changes in market values primarily due to interest rate changes. All of the Company's securities in an unrealized loss position as of June 30, 2013 had been in an unrealized loss position for less than twelve months. The Company intends to hold these securities until maturity and the possibility that the Company will be required to sell these securities prior to the recovery of their amortized cost basis is remote. No other-than-temporary impairment charges were recorded during the three and six months ended June 30, 2013 and 2012 .

The following table summarizes the remaining contractual maturities of the Company’s marketable securities, in thousands:

	As of June 30, 2013	As of December 31, 2012
Due within one year	$ 5,706	$ 7,929
Due after one year through five years	31,522	14,350
Total	$ 37,228	$ 22,279

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Maturities of tax-exempt marketable securities	$ 750	$ 12,970	$ 7,135	$ 32,035
Total	$ 750	$ 12,970	$ 7,135	$ 32,035

The Company did not record any gross realized gains or gross realized losses in net income during the three and six months ended June 30, 2013 and 2012 . Additionally, there were no proceeds from sales of marketable securities during the three and six months ended June 30, 2013 and 2012 .

6 . Fair Value Measurements

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

Description	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	Fair Value Measurements as of June 30, 2013 Using			
Assets:				
Cash and cash equivalents:				
Cash	$ 40,893	$ 40,893	$ —	$ —
Money market funds	42,728	42,728	—	—
Variable rate demand notes	23,960	23,960	—	—
Marketable securities:				
Tax-exempt municipal securities	37,228	—	37,228	—
Total assets at fair value on a recurring basis:	$ 144,809	$ 107,581	$ 37,228	$ —
Liabilities:				
Accrued liabilities:				
RDI contingent consideration	$ 6,186	$ —	$ —	$ 6,186
Total liabilities at fair value on a recurring basis:	$ 6,186	$ —	$ —	$ 6,186

Description	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	Fair Value Measurements as of December 31, 2012 Using			
Assets:				
Cash and cash equivalents:				
Cash	$ 21,122	$ 21,122	$ —	$ —
Money market funds	643	643	—	—
Variable rate demand notes	71,455	71,455	—	—
Marketable securities:				
Tax-exempt municipal securities	22,279	—	22,279	—
Total assets at fair value on a recurring basis:	$ 115,499	$ 93,220	$ 22,279	$ —
Liabilities:				
Other liabilities:				
RDI contingent consideration	$ 6,252	$ —	$ —	$ 6,252
Total liabilities at fair value on a recurring basis:	$ 6,252	$ —	$ —	$ 6,252

The Company measures cash and cash equivalents at fair value primarily using real-time quotes for transactions in active exchange markets involving identical assets. The Company's marketable securities are classified within Level 2 and are valued using readily available pricing sources for comparable instruments utilizing market observable inputs. The Company does not hold securities in inactive markets. The Company did not have any transfers of assets between Level 1 and Level 2 of the fair value measurement hierarchy during the six months ended June 30, 2013 and 2012 .

Level 3 Measurements

RDI Contingent Consideration

In connection with the acquisition of RDI, the Company is required to make an additional payment contingent on whether RDI is awarded Taught Degree Awarding Powers (TDAP) by the British government. Refer to Note 14 of the Company's 2012 Annual Report on Form 10-K for additional details regarding the acquisition of RDI. As the contingent consideration is classified as a liability, ASC 805 *Business Combinations* (ASC 805) requires that the Company re-measure the liability at fair

value at each reporting date until it is extinguished. As such, the Company classified the RDI contingent consideration liability within Level 3 of the fair value measurement hierarchy.

The fair value of the RDI contingent consideration as of June 30, 2013 was determined using the discounted cash flow approach and based on the present value of the probability-weighted expected cash flows using estimates of the timing and probability of RDI being awarded TDAP. The discount rate reflects the risk of a market participant who holds the corresponding asset. To estimate the discount rate, the Company considered the weighted average cost of capital of the business risk associated with RDI being awarded TDAP. The discount rate was then adjusted to incorporate a risk-free rate and costs of debt for a term commensurate with the term in which the contingent consideration payment is expected to be made, as well as the low probability risk of the contingent consideration payments not being made.

The fair value measurement of the RDI contingent consideration encompasses the following significant unobservable inputs:

Unobservable Inputs	Range
Weighted average cost of capital	5%
Timing of cash flows	0 - 24 months
Probability of TDAP achievement	100%

Significant increases or decreases in any of the unobservable inputs in isolation would result in a lower or higher fair value measurement of the RDI contingent consideration. An increase in the weighted average cost of capital would result in a decrease in the fair value, an acceleration of the timing of cash flows would increase the fair value, and a decrease in the probability that TDAP will be achieved would reduce the fair value. Reasonable changes in the unobservable inputs do not result in a material change in the fair value.

The following table presents a reconciliation of the fair value of the RDI contingent consideration, in thousands:

Balance, December 31, 2012	$	6,252
Decrease of RDI contingent consideration liability		(66)
Balance, June 30, 2013	$	6,186

The change in the fair value of the RDI contingent consideration liability was recorded in other income (expense), net in the consolidated statements of income during the six months ended June 30, 2013 and 2012 . The decrease in the fair value during the second quarter of 2013 was a result of revising the expected timing of RDI being awarded TDAP. The fair value of the RDI contingent consideration liability was recorded in accrued liabilities and other liabilities in the consolidated balance sheets as of June 30, 2013 and December 31, 2012 , respectively.

7. Accrued Liabilities

Accrued liabilities consist of the following, in thousands:

	As of June 30, 2013	As of December 31, 2012
Accrued compensation and benefits	$ 8,796	$ 9,165
Accrued instructional	6,220	6,172
Accrued vacation	1,976	1,112
RDI contingent consideration	6,186	—
Other	12,536	9,943
Total	$ 35,714	$ 26,392

“Other” in the table above consists primarily of vendor invoices accrued in the normal course of business.

8. Commitments and Contingencies

Operating Leases

The Company leases its office facilities and certain office equipment under various noncancelable operating leases and has contractual obligations related to certain software license agreements. Effective August 29, 2011, the Company entered into an amendment of its lease with Minneapolis 225 Holdings, LLC pursuant to which the Company renewed and extended its

existing lease for premises at 225 South Sixth Street in Minneapolis, Minnesota through 2018. Renewal terms under this lease allow the Company to extend the lease for up to two additional five -year terms.

The following presents the Company's future minimum lease commitments as of June 30, 2013 , in thousands:

2013	$	3,281
2014		6,459
2015		6,520
2016		6,553
2017		6,688
2018 and thereafter		5,595
Total	$	35,096

The Company recognizes rent expense on a straight-line basis over the term of the lease, although the lease may include escalation clauses providing for lower payments at the beginning of the lease term and higher payments at the end of the lease term. Cash or lease incentives received from lessors are recognized on a straight-line basis as a reduction to rent from the date the Company takes possession of the property through the end of the lease term. The Company records the unamortized portion of the incentive as a component of deferred rent, in accrued liabilities or long-term liabilities, as appropriate.

On January 4, 2012, RDI entered into an agreement to assign its lease in the UK to Glasgow Caledonian University (GCU) for the remainder of the lease term, which expires in May 2020. Under the terms of the agreement, GCU covenants to the Lessor that it will pay the remaining rents under the lease term. However, the Lessor required that RDI act as guarantor for GCU in the event GCU defaults under the lease. The Company believes default by GCU under the lease, and therefore any future payment by RDI under this arrangement, is remote.

Revolving Credit Facility

On September 30, 2011, the Company entered into an unsecured revolving credit agreement (the Credit Agreement) with Bank of America, N.A., and certain other lenders. The Credit Agreement provides $100.0 million of borrowing capacity (the credit facility), with an increase option of an additional $50.0 million . The Credit Agreement expires on September 30, 2016 .

Borrowings under the Credit Agreement bear interest at a rate equal to LIBOR plus an applicable rate of 1.75% to 2.25% based on the Company’s consolidated leverage ratio or, at the Company’s option, an alternative base rate (defined as the higher of (a) the federal funds rate plus 0.5% , (b) Bank of America’s prime rate, or (c) the one-month LIBOR plus 1.0%) plus an applicable rate of 0.75% to 1.25% based on the Company’s consolidated leverage ratio. The Credit Agreement requires payment of a commitment fee, based on the Company’s consolidated leverage ratio, charged on the unused credit facility. Outstanding letters of credit are also charged a fee, based on the Company’s consolidated leverage ratio. The Company capitalized approximately $0.5 million of debt issuance costs related to the credit facility, which are being amortized on a straight-line basis over a period of five years. Interest expense for the amortization of debt issuance costs is recorded in other income (expense), net.

The Credit Agreement contains certain covenants that, among other things, require maintenance of certain financial ratios, as defined in the agreement. Failure to comply with the covenants contained in the Credit Agreement will constitute an event of default and could result in termination of the agreement and require payment of all outstanding borrowings. As of June 30, 2013 , there were no borrowings under the credit facility and the Company was in compliance with all debt covenants.

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. While the outcome of these matters is uncertain, the Company does not believe the outcome of these matters will have a material adverse impact on its consolidated financial position or results of operations.

9. Share Repurchase Program

The Company announced its current share repurchase program in July 2008. The Board of Directors authorizes repurchases of outstanding shares of common stock from time to time depending on market conditions and other considerations. A summary of

the Company’s comprehensive share repurchase activity from the program's commencement through June 30, 2013 , all of which was part of its publicly announced program, is presented below, in thousands:

Board authorizations:	
July 2008	$ 60,000
August 2010	60,662
February 2011	65,000
December 2011	50,000
Total amount authorized	235,662
Total value of shares repurchased	229,520
Residual authorization	$ 6,142

The following table summarizes shares repurchased, in thousands:

	Six Months Ended June 30,	
	2013	2012
Shares repurchased	55	709
Total consideration, excluding commissions	$ 2,135	$ 25,455

As of June 30, 2013 , the Company had purchased an aggregate of 5.2 million shares under the program’s outstanding authorizations at an average price per share of $43.72 totaling $229.5 million .

10. Share-Based Compensation

The table below reflects the Company’s stock-based compensation expense recognized in the consolidated statements of income for the three and six months ended June 30, 2013 and 2012 :

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Instructional costs and services	$ 294	$ 241	$ 761	$ 539
Marketing and promotional	94	76	243	192
Admissions advisory	10	13	26	26
General and administrative	626	488	1,576	1,176
Share-based compensation expense included in operating income	1,024	818	2,606	1,933
Tax benefit from share-based compensation expense	379	305	964	721
Share-based compensation expense, net of tax	$ 645	$ 513	$ 1,642	$ 1,212

On May 7, 2013, the Company's Board of Directors approved an award in the form of MSUs to its Chairman and CEO, which are full-value shares that vest upon reaching a certain stock price at the end of a five-year service period. Refer to the Company's May 7, 2013 Current Report on Form 8-K for key terms and details of the award.

11. Acquisitions

Sophia Learning, LLC

The Company acquired a majority ownership interest in Sophia in 2010. The equity interest in Sophia not owned by the Company was reported as noncontrolling interest on the consolidated balance sheet of the Company. Losses incurred by Sophia were charged to the Company and to the noncontrolling interest holder based on ownership percentage.

On April 16, 2012 , the Company acquired the remaining interest in Sophia for approximately $1.6 million in an arms-length transaction. The Company began accounting for Sophia as a wholly owned subsidiary beginning in the second quarter of 2012 when the noncontrolling interests were acquired.

12. Accumulated Other Comprehensive Income

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

	Foreign Currency Translation (Loss) Gain	Unrealized Gains (Loss) on Marketable Securities	Accumulated Other Comprehensive (Loss) Income [1]
Beginning balance, December 31, 2012	$ (32)	$ 10	$ (22)
Current period change	188	(21)	167
Ending balance, June 30, 2013	$ 156	$ (11)	$ 145

(1) Accumulated other comprehensive (loss) income is presented net of tax of $7 thousand and $6 thousand as of June 30, 2013 and December 31, 2012 , respectively.

13. Regulatory Supervision and Oversight

Political and budgetary concerns significantly affect the Title IV Programs. Congress reauthorizes the Higher Education Act (HEA) and other laws governing Title IV Programs approximately every five to eight years. The last reauthorization of the HEA was completed in August 2008. Additionally, Congress reviews and determines appropriations for Title IV programs on an annual basis through the budget and appropriations processes. As of June 30, 2013 , programs in which the University's learners participate are operative and sufficiently funded.

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

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

Forward-Looking Statements

Statements contained in this Quarterly Report on Form 10-Q that are not statements of historical fact should be considered forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 (the "Act"). In addition, certain statements in our future filings with the Securities and Exchange Commission (SEC), in press releases, and in oral and written statements made by us 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, 2012 , as updated in our subsequent reports filed with the SEC, including any updates found in Part II, Item 1A of this or other Quarterly Reports on Form 10-Q. The performance of our business and our securities may be adversely affected by these factors and 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 SEC.

Executive Overview

We are an online postsecondary education services company. As of June 30, 2013 , our wholly owned subsidiaries included the following:

- Capella University (the University) is a regionally accredited university that offers a variety of undergraduate and graduate degree programs primarily for working adults.

- Resource Development International Limited (RDI) is an independent provider of United Kingdom (UK) university distance learning qualifications that markets, develops and delivers these programs worldwide via its offices and partners across Asia, North America, Africa and Europe.
- Sophia Learning, LLC (Sophia) is a social teaching and learning platform that integrates education with technology.

We believe we have the right operating strategies in place to continually differentiate ourselves in our markets and drive growth by supporting learner success, producing affordable degrees, expanding our comprehensive marketing strategy, serving a broader set of our learner's professional needs and establishing new growth platforms. Technology and the talent of our faculty and employees enable these strategies. We believe these strategies and enablers will allow us to continue to deliver high quality, affordable education, resulting in continued growth over the long-term. We will continue to invest in these enablers to strengthen the foundation and future of our business.

Key Trends, Developments and Challenges

The following developments and trends present opportunities, challenges and risks toward achieving our goal of providing attractive returns to our shareholders:

- *Initiatives to improve learner success* . As we continue to position Capella to drive sustainable growth, we are focused on improving learner success rates particularly in the first four quarters of enrollment, while maintaining a high standard of academic quality and rigor. We have implemented various measures likely to affect our growth and profitability, at least in the near-term, including the following:

  - Investing in our actionable analytics capabilities to further leverage data, refine our models and accurately predict the likelihood of a prospective and new learner persisting to critical thresholds of success in the learner's first four quarters of enrollment;
  - Piloting programs such as assessments and orientations to create personalized pathways for different learner groups which focus on transitioning learners into the online environment, creating a supportive community, and providing a proactive support structure;
  - Providing timely and clear information to our learners, faculty, advisors and staff to help learners persist and successfully complete their programs;
  - Optimizing our marketing approaches to increase emphasis on attracting learners who are more likely to persist in our programs;
  - Promoting affordability and encouraging learners to remain enrolled by offering learner success grants to new learners who meet admissions requirements, enroll, and apply within certain timeframes; and,
  - Diversifying outside of Capella University by creating innovative new learning technologies that have potential to increase affordability, and better serve the life-long learning needs of working adult professionals and therefore increase learner success.

  As a result of these initiatives, early cohort persistence improved by approximately five percent during the second quarter of 2013, compared to the same period in the prior year. Early cohort persistence measures the four-quarter weighted moving average new cohort persistence rate. Our learner success strategy primarily focuses on the first four quarters, since learners tend to persist at a very high rate after that time period. Although our early persistence initiative results have been positive, some of these initiatives may adversely impact our new and active enrollment, revenue, and operating margins at times. We believe these efforts are in the best interest of our learners and over the long-term will improve learner success and lifetime revenue, which, in turn, positions us for more sustainable long-term growth.

- *New enrollment and persistence.* Capella University new enrollments in the second quarter of 2013 grew 12.7 percent, calculated from last day a new learner can drop a course without financial penalty. New enrollment growth in the second quarter of 2013 resulted from strong performance across all degree programs. Although new enrollment growth is an important metric, the combination of new enrollment and persistence are key drivers for total enrollment and revenue performance. We are building a sustainable business model focused on total enrollment growth.

- *Comprehensive marketing strategy.* Our strategic shift from a demand driven strategy towards a comprehensive marketing strategy, which is focused on building relationships with prospective learners early in the decision cycle, reinforces our commitment to quality inquiries by:

  - Introducing prospective learners to Capella through channels such as mass media and strategic relationships with employers,
  - Connecting with prospective learners by generating and nurturing inquiries through direct media such as natural search, our website, and display media, and
  - Engaging with prospective learners by developing meaningful relationships such as through social media or direct engagement.

  We believe our comprehensive marketing strategy will produce long-term efficiencies and increase our ability to attract high-quality learners on a long-term sustainable basis. However, some of these initiatives may adversely impact our new enrollment, revenues, and operating margins for a period of time as we pursue improved long-term results.

- *Current market and regulatory environment.* The market continues to present challenging conditions and competition is strong; however, we remain focused on attracting the right learners and learner success. We believe our initiatives to improve learner success through innovation will position us to continue to be a leader in the online postsecondary education market. Additionally, we are working to even more closely align with employers. Developments in the federal regulatory environment impact us as well, including the upcoming reauthorization of the Higher Education Act of 1965, as amended, and the current Department of Education rulemaking process. Many states have also become more active in regulating on-line education and enforcing consumer protection laws, especially with proprietary institutions. While we have a strong track record of regulatory compliance, such actions, even if not directed at Capella University, may make our operating environment more challenging.

- *Establishing new growth platforms.* We seek to drive long-term growth that is an extension of our core competencies into new markets. We are pursuing this extension through a small business development team that is exploring early stage opportunities. This may result in increased new business development costs focused on researching, identifying, and cultivating these new opportunities.

  In July 2011, we acquired RDI, which is serving the fast-growing online international higher education market. RDI has a presence in the UK and certain other countries. Although the acquisition had a positive impact on our revenue growth, RDI was dilutive to our earnings in the first six months of 2013, and is expected to be dilutive to our earnings throughout the remainder of 2013. If this trend continues and operating improvements are not realized, some or all of the goodwill could be impaired in the future. We believe the fair value of the RDI reporting unit remains in excess of the carrying value as of June 30, 2013. Management will assess goodwill for impairment in the fourth quarter in 2013, or earlier if events occur or circumstances change between annual tests that would more likely than not reduce the fair value of the respective reporting unit below its carrying amount.

- *Redesign of programs and specializations* . In our continued efforts to drive affordability and speed to competency, we are focused on maximizing efficiencies in our existing programs while delivering the same learning outcomes. Our curriculum is based on competency mappings, which we are able to leverage as we redesign existing offerings. We believe these types of redesigns have the potential to increase persistence rates, learner success, and affordability.

- *New learning models.* We received approval from The Higher Learning Commission for two direct assessment programs for which we applied, the Master's of Business Administration in General Business Administration and Bachelor's in Business Administration. This new learning model, called FlexPath, allows learners to complete course work at their own pace throughout each quarter and complete activities to demonstrate specific competencies by the end of the quarter. We are currently waiting for approval by the Department of Education (the Department) of our FlexPath offerings before opening enrollment into the programs. We believe this direct assessment model provides an opportunity to expand our served market and increase affordability, including tuition costs, time to completion, and flexibility.

Regulatory Environment

The following summarizes significant regulatory matters applicable to our business. For a more detailed discussion of the regulatory environment and related risks, refer to Part 2, Item 7, *Key Trends, Developments and Challenges,* and *Regulatory Environment* in our 2012 Annual Report on Form 10-K for the fiscal year ended December 31, 2012 .

- *Announcement of New Rulemaking by the U.S. Department of Education.* On April 15, 2013 the Department announced its intent to establish a negotiated rulemaking committee covering the following areas: Title IV Federal Student Aid; changes to the definition of “adverse credit” for borrowers in the Federal Direct PLUS Loan program; state authorization pertaining to distance and correspondence education; state authorization for foreign locations of institutions; clock-to-credit hour conversions; gainful employment; and changes made to the Violence Against Women Act. The Department held three public hearings in May 2013 for interested parties to provide comments on these topics with negotiations beginning in September 2013. The Department indicated that this proposed rulemaking would be part of a series of rulemakings to achieve a long-term agenda in higher education focused on: access, affordability, academic quality and completion. On June 12, 2013 the Department announced the first in its series of rulemakings by issuing a call for nominations to serve on the committee focusing on gainful employment. The committee is scheduled to meet September 9 through 11, and October 21 through 23, 2013. This rulemaking committee will not meet the November 1, 2013 publication deadline for a July 1, 2014 effective date. Therefore, the earliest effective date for regulations coming out of this round of rulemaking would be July 1, 2015.

- *Background on Gainful Employment Rulemaking by the Department.* In 2010, the Department issued Title IV program integrity rules that addressed numerous topics, including the adoption of a definition of “gainful employment” for purposes of the requirement for Title IV student financial aid that a program of study offered by a proprietary institution prepare learners for gainful employment in a recognized occupation.

  On June 30, 2012, one day before the regulation was scheduled to take legal effect, the U.S. District Court for the District of Columbia vacated the Gainful Employment “debt measures” regulation in its entirety, largely on grounds that the loan repayment rate aspect of the regulations was arbitrary and capricious. Although the District Court vacated the debt measures regulation - including the loan repayment and debt-to-income metrics promulgated by the Department to assess whether a program prepared students for gainful employment - and the related institutional reporting requirements and new program approval regulations, the Gainful Employment program disclosure requirements that took effect July 1, 2011 were left intact. On July 30, 2012 the Department filed a motion with the District Court to reinstate the requirement that institutions report information used to calculate student loan-repayment rates and debt-to-income ratios. On March 20, 2013 the District Court denied the Department's request to amend the June 30, 2012 decision vacating the Gainful Employment rules. The Court largely relied upon provisions within the Higher Education Act (HEA) that expressly prohibit the maintenance of a Federal database of personally identifiable information on individual students, unless necessary for the operation of certain HEA programs (such as the National Student Loan Data Systems (NSLDS), which was authorized by statute). The Court rejected the Department's argument that it is allowed significant leeway or deference in expanding the information that is collected within NSLDS. The Court stated that the purpose of NSLDS is to collect information regarding grants and loans made to students under various Federal programs. The Court further stated that the overall purpose of NSLDS has never been to collect information regarding students who do not receive Federal Student Aid, that such an expansion of the database was contrary to the HEA, and that the Department is prohibited from creating a student unit record system of information on all students in Gainful Employment programs. The Court's decision means that even if the Department were able to alter the Gainful Employment metrics regarding graduates' loan repayment rates and debt levels in a manner that was acceptable to the Court, this decision's holding that the Department cannot maintain a student unit record system for students in Gainful Employment programs appears to make it extremely difficult, if not impossible, for the Department to collect the data needed to implement and enforce the Gainful Employment Regulations.

  While the District Court found that the Department did possess statutory authority to define “gainful employment” by regulation and to develop specific metrics as part of such regulations, the Department has not appealed the decision to the U.S. Court of Appeals for the District of Columbia Circuit. The court's decision still stands and the Gainful Employment Debt Measures regulation did not take effect on July 1, 2012.

- *Minnesota Office of Higher Education Student Debt Information Request.* The Minnesota Office of Higher Education (MOHE) is developing state level metrics related to Average Student Loan Debt. The data request was sent to all schools located within the state. The final report will be published by institution and sector (public 2-year, public 4-year, private not-for-profit, and private for-profit) covering average educational loan debt (excluding

PLUS loans) of degree recipients by award level for 2009-2010. The student loan debt is debt from all sources (federal, state, institution, private) known to the institution. We are working with MOHE on this request. The date for the report to be published has not been determined.

- *Student Loan Cohort Default Rates* . To remain eligible to participate in Title IV programs, an educational institution's student loan cohort default rates must remain below certain specified levels. Under current regulations, an educational institution will lose its eligibility to participate in Title IV programs if its two-year measuring period student loan cohort default rate equals or exceeds 25% for three consecutive cohort years, or 40% for any given year. Capella University's two-year cohort default rates for the 2010 and 2009 cohorts are 7.0% and 6.6%, respectively. This increase is primarily due to the overall economic environment, and an increased percentage of Capella University learners enrolled in a bachelor's program, who generally have a higher default rate compared to graduate learners. During the first quarter of 2013, the 2011 two-year draft cohort default rates were released by the Department. Capella University's 2011 two-year draft cohort default rate is 10.3%. The 2011 two-year draft rate will be finalized in September 2013.

  The cohort default rate requirements were modified by the Higher Education Opportunity Act enacted in August 2008 to increase by one year the measuring period for each cohort. Starting in September 2012, the Department published the official three-year cohort default rates in addition to the two-year rates, beginning with the 2009 cohort. If an institution's three-year cohort default rate exceeds 30% for three consecutive years (compared to 25% under the current two-year standard), it must establish a default prevention task force and develop a default prevention plan with measurable objectives for improving the cohort default rate. We believe that our current repayment management efforts meet these requirements.

  If an institution's three-year cohort default rates for the 2009 and 2010 cohorts exceed 30%, the institution may be subject to provisional certification imposing various additional requirements for participation in Title IV programs. Beginning with the three-year cohort default rate for the 2011 cohort published in September 2014, the three-year rates will be applied for purposes of measuring compliance with the requirements. If the three-year cohort default rate for the 2011 cohort exceeds 40%, the institution will cease to be eligible to participate in Title IV programs, and if the institution's three-year cohort default rate exceeds 30% for three consecutive years, beginning with the 2009 cohort, the institution will cease to be eligible to participate in Title IV programs. The Department has published, for informational purposes, “trial rates” to assist institutions in understanding the impact of the new three-year cohort default rate calculation. Capella University's three-year cohort default rate for the 2009 cohort is 9.7%, and its trial three-year cohort default rate for the 2008 cohort is 6.5%. This increase is primarily due to the overall economic environment, and an increased percentage of Capella University learners enrolled in a bachelor's program, who generally have a higher default rate compared to graduate learners. During the first quarter of 2013, the 2010 three-year draft cohort default rates were released by the Department. Capella University's 2010 three-year draft cohort default rate is 10.9%. The 2010 three-year draft rate will be finalized in September 2013.

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, 2012 . As a result of a grant of market stock units (MSUs) to our Chairman and CEO during the three months ended June 30, 2013 , we have updated our share-based compensation critical accounting policy to include the following:

Share-Based Compensation

On May 7, 2013, the Company's Board of Directors approved an award in the form of Market Stock Units (MSUs) to its Chairman and CEO, which are full-value shares that vest upon reaching a certain stock price at the end of a five-year service period. Refer to the Company's May 7, 2013 Current Report on Form 8-K for key terms and details of the award.

We measure and recognize compensation expense for share-based payment awards made to employees and directors, including market stock units, based on estimated fair values of the share award on the date of grant. The fair value of our MSUs is estimated as of the date of grant using a Monte Carlo simulation. The Monte Carlo simulation is based on the expected 90 calendar day average market price of our common stock prior to the vesting date and the expected number of MSUs that will convert into common shares. In determining share-based compensation for MSUs, the Monte Carlo simulation approach is applied in a risk-neutral framework with inputs including volatility, the risk-free interest rate, and expected dividends. When estimating the grant date fair value of the MSUs, the daily closing prices of the our stock are forecast over the 90 calendar days ending on the last day of the service period, using a Monte Carlo simulation. Numerous iterations of the Monte Carlo simulation are performed, based on the framework described above, to develop a distribution of future stock price paths. The estimated fair value of an MSU equals the average of the discounted present values from each of the simulation paths produced

by the Monte Carlo simulation. The Company recognizes share-based compensation expense for MSU awards using the straight-line method, over the period that the awards are expected to vest. Compensation cost related to an award with a market condition will be recognized regardless of whether the market condition is satisfied, provided that the requisite service has been provided.

Results of Operations

Three Months Ended June 30, 2013 Compared to Three Months Ended June 30, 2012

The following selected financial data table should be referenced in connection with a review of the discussion of our results of operations for the three months ended June 30, 2013 :

	Three Months Ended June 30,						
	$ (in thousands, unaudited)		$ Change	% Change	% of Revenue		
	2013	2012	2013 vs. 2012		2013	2012	2013 vs. 2012
Revenues	$ 103,693	$ 106,180	$ (2,487)	(2.3)%	100.0%	100.0%	0.0 %
Costs and expenses:							
Instructional costs and services	44,900	46,704	(1,804)	(3.9)	43.3	44.0	(0.7)
Marketing and promotional	24,101	25,437	(1,336)	(5.3)	23.3	24.0	(0.7)
Admissions advisory	6,727	7,482	(755)	(10.1)	6.5	7.0	(0.5)
General and administrative	10,500	8,501	1,999	23.5	10.1	8.0	2.1
Total costs and expenses	86,228	88,124	(1,896)	(2.2)	83.2	83.0	0.2
Operating income	17,465	18,056	(591)	(3.3)	16.8	17.0	(0.2)
Other income (expense), net	(25)	60	(85)	(141.7)	—	0.1	(0.1)
Income before income taxes	17,440	18,116	(676)	(3.7)	16.8	17.1	(0.3)
Income tax expense	7,018	6,704	314	4.7	6.8	6.3	0.5
Effective tax rate	*40.2 %*	*37.0 %*					
Net income attributable to Capella Education Company	$ 10,422	$ 11,412	$ (990)	(8.7)%	10.0%	10.8%	(0.8)%

Revenues. The decrease in revenues compared to the same quarter in the prior year was primarily related to a 0.9 percent decrease in total Capella University enrollments at June 30, 2013 compared to the same period in 2012, a larger proportion of bachelor's and certificate learners who generate less revenue per learner than our master's and doctoral learners, and an increase in tuition grants to support our initiatives to improve learner success. This decrease was slightly offset by growth in our new market platforms and Capella University price increases. Capella University tuition increases in 2013 averaged approximately two percent and were implemented in July 2012.

Instructional costs and services expenses. Instructional costs and services expenses, and instructional costs and services expenses as a percent of revenue, decreased compared to the same quarter in the prior year primarily due to a decrease in depreciation expense as a result of our enterprise resource planning system becoming fully depreciated in the prior year. This decrease was partially offset by increased expenses related to our diversification efforts.

Marketing and promotional expenses. Marketing and promotional expenses, and marketing and promotional expenses as a percent of revenue, decreased compared to the same quarter in the prior year primarily due to efficiencies gained in our Capella University marketing efforts through utilization of a more balanced approach as we continue to optimize our relationship-based and brand marketing model, and timing of marketing expenses. These decreases were partially offset by increased investments in RDI's marketing platform, depreciation expense as a result of investments in strategic initiatives throughout 2012, and information technology investments related to improving the visitor center.

Admissions advisory expenses. Admissions advisory expenses, and admissions advisory expenses as a percent of revenue, decreased compared to the same quarter in the prior year primarily due to higher information technology expenses in the prior year associated with enterprise wide foundational upgrades and strategic initiatives, and increased staff productivity in 2013.

General and administrative expenses. General and administrative expenses, and general and administrative expenses as a percent of revenue, increased compared to the same quarter in the prior year primarily as a result of the prior year reversal of the Office of Inspector General (OIG) audit accrual, for our estimated total amount of Title IV funds not returned for learners

who withdrew without providing official notification of approximately $1.0 million, including interest, but not including fines and penalties; and increased bonus expense.

Other income (expense), net. Other income (expense), net was $25 thousand of expense for the three months ended June 30, 2013, and $60 thousand of income for the three months ended June 30, 2012. The increase in expense compared to the same quarter in the prior year was primarily due to reduced interest income levels as a result of the lower average marketable securities balance in 2013. This increase was partially offset by the decrease in the fair value of the RDI contingent consideration liability in the second quarter of 2013, as a result of expected timing of future cash flows.

Income tax expense. The increase in our effective tax rate compared to the same quarter in the prior year was a result of our inability to utilize the foreign operating losses which are subject to a full valuation allowance as well as a decrease in the favorable impact of tax exempt interest.

Net income. Net income decreased due to the factors discussed above.

Six Months Ended June 30, 2013 Compared to Six Months Ended June 30, 2012

The following selected financial data table should be referenced in connection with a review of the discussion of our results of operations for the six months ended June 30, 2013 :

	Six Months Ended June 30,						
	$ (in thousands, unaudited)		$ Change	% Change	% of Revenue		
	2013	2012	2013 vs. 2012		2013	2012	2013 vs. 2012
Revenues	$ 208,935	$ 215,580	$ (6,645)	(3.1)%	100.0 %	100.0%	0.0 %
Costs and expenses:							
Instructional costs and services	91,867	95,137	(3,270)	(3.4)	44.0	44.1	(0.1)
Marketing and promotional	49,602	50,859	(1,257)	(2.5)	23.7	23.6	0.1
Admissions advisory	13,498	15,170	(1,672)	(11.0)	6.5	7.1	(0.6)
General and administrative	21,328	18,421	2,907	15.8	10.2	8.5	1.7
Total costs and expenses	176,295	179,587	(3,292)	(1.8)	84.4	83.3	1.1
Operating income	32,640	35,993	(3,353)	(9.3)	15.6	16.7	(1.1)
Other income (expense), net	(225)	17	(242)	(1,423.5)	(0.1)	—	(0.1)
Income before income taxes	32,415	36,010	(3,595)	(10.0)	15.5	16.7	(1.2)
Income tax expense	13,238	13,491	(253)	(1.9)	6.3	6.3	—
Effective tax rate	*40.8 %*	*37.5 %*					
Net income	19,177	22,519	(3,342)	(14.8)	9.2	10.4	(1.2)
Net loss attributable to noncontrolling interest	—	186	(186)	(100.0)	—	0.1	(0.1)
Net income attributable to Capella Education Company	$ 19,177	$ 22,705	$ (3,528)	(15.5)%	9.2 %	10.5%	(1.3)%

Revenues. The decrease in revenues compared to the same period in the prior year was primarily related to a 0.9 percent decrease in total Capella University enrollments at June 30, 2013 compared to the same period in 2012, a larger proportion of bachelor's and certificate learners who generate less revenue per learner than our master's and doctoral learners, and an increase in tuition grants to support our initiatives to improve learner success. This decrease was slightly offset by Capella University price increases and growth in our new market platforms. Capella University tuition increases in 2013 averaged approximately two percent and were implemented in July 2012.

Instructional costs and services expenses. Instructional costs and services expenses, and instructional costs and services expenses as a percent of revenue, decreased compared to the same period in the prior year primarily due to a decrease in depreciation expense as a result of our enterprise resource planning system becoming fully depreciated in the prior year, and an impairment charge related to property and equipment in the prior year's first quarter. These decreases were partially offset by increased expenses related to our diversification efforts.

Marketing and promotional expenses. Marketing and promotional expenses decreased compared to the same period in the prior year primarily due to efficiencies gained in our Capella University marketing efforts through utilization of a more

balanced approach as we continue to optimize our relationship-based and brand marketing model. This decrease was partially offset by increased investments in RDI's marketing platform, depreciation expense as a result of investments in strategic initiatives throughout 2012, and information technology investments related to improving the the visitor center.

Admissions advisory expenses. Admissions advisory expenses, and admissions advisory expenses as a percent of revenue, decreased compared to the same period in the prior year primarily due to higher information technology expenses in the prior year associated with enterprise wide foundational upgrades and strategic initiatives, and increased staff productivity in 2013.

General and administrative expenses. General and administrative expenses, and general and administrative expenses as a percent of revenue, increased compared to the same quarter in the prior year primarily as a result of the prior year reversal of the Office of Inspector General (OIG) audit accrual, for our estimated total amount of Title IV funds not returned for learners who withdrew without providing official notification of approximately $1.0 million, including interest, but not including fines and penalties; and increased bonus expense.

Other income (expense), net. Other income (expense), net was $0.2 million of expense for the six months ended June 30, 2013, and $17 thousand of income for the six months ended June 30, 2012. The increase in expense compared to the same quarter in the prior year was primarily due to reduced interest income levels as a result of the lower average marketable securities balance in 2013. This increase was partially offset by the decrease in the fair value of the RDI contingent consideration liability in the second quarter of 2013, as a result of expected timing of future cash flows.

Income tax expense. The increase in our effective tax rate compared to the same quarter in the prior year was a result of our inability to utilize the foreign operating losses which are subject to a full valuation allowance as well as a decrease in the favorable impact of tax exempt interest.

Net income. Net income decreased due to the factors discussed above.

Liquidity and Capital Resources

Liquidity

We financed our operating activities and capital expenditures during the six months ended June 30, 2013 and 2012 primarily through cash provided by operating activities. Our cash, cash equivalents and marketable securities were $144.8 million and $115.5 million at June 30, 2013 and December 31, 2012 , respectively.

On September 30, 2011, we entered into an unsecured revolving credit agreement (the Credit Agreement) with Bank of America, N.A., and certain other lenders. The Credit Agreement provides $100.0 million of borrowing capacity, with an increase option of an additional $50.0 million. The Credit Agreement term ends September 30, 2016. As of June 30, 2013 , there were no borrowings under the credit facility and we were in compliance with all debt covenants.

Significant portions of our revenues are derived from Title IV programs. Federal regulations dictate the timing of disbursements under Title IV programs. Learners must apply for new loans and grants each academic year, which begins July 1. Loan funds are provided through the William D. Ford Direct Loan program in multiple disbursements for each academic year. The disbursements are usually received by the beginning of the third week of the term. These factors, together with the timing of when our learners begin their programs, affect our operating cash flow. Based on current market conditions and recent regulatory or legislative actions, we do not anticipate any significant near-term disruptions in the availability of Title IV funding for our learners.

On July 15, 2011, we acquired 100% of the share capital of RDI for £7.9 million (approximately $12.6 million), net of cash acquired. In connection with the agreement, we will make an additional payment of £4.0 million (approximately $6.4 million) if RDI is granted Taught Degree Awarding Power (TDAP).

Based on our current level of operations and anticipated growth, we believe our cash provided by operations and other sources of liquidity, including cash, cash equivalents and marketable securities, will provide adequate funds for ongoing operations and planned capital expenditures for the foreseeable future. We can further supplement our liquidity position with the $100.0 million credit facility to fund our operations or to fund strategic investments, if needed.

Operating Activities

Net cash provided by operating activities was $41.6 million and $35.6 million for the six months ended June 30, 2013 and 2012 , respectively. The increase was primarily due to the effects of changes in operating assets and liabilities, partially offset by a decrease in net income.

Investing Activities

Net cash used in investing activities is primarily related to the purchase or maturity of investments in marketable securities and investments in property and equipment. Net cash used in investing activities was $25.6 million for the six months ended June 30, 2013 . Net cash provided by investing activities was $19.1 million for the six months ended June 30, 2012 .

Cash used in investing activities for the six months ended June 30, 2013 consisted primarily of purchases of tax-exempt municipal securities and investments in property and equipment, which were partially offset by maturities of marketable securities. Net purchases and maturities of marketable securities represented a cash outflow of $15.3 million during the six months ended June 30, 2013 , and maturities of marketable securities represented a cash inflow of $32.0 million during the six months ended June 30, 2012 . The maturities of marketable securities in 2012 were primarily held as cash and cash equivalents at June 30, 2012.

We believe the credit quality and liquidity of our investment portfolio as of June 30, 2013 is strong. The unrealized gains and losses of the portfolio may remain volatile as changes in the general interest rate environment and supply/demand fluctuations of the securities within our portfolio impact daily market valuations. To mitigate the risk associated with this market volatility, we deploy a relatively conservative investment strategy focused on capital preservation and liquidity. But even with this approach, we may incur investment losses as a result of unusual and unpredictable market developments and we may experience reduced investment earnings if the yields on investments deemed to be low risk remain low or decline further due to unpredictable market developments. In addition, these unusual and unpredictable market developments may also create liquidity challenges for certain of the assets in our investment portfolio.

Capital expenditures were $10.3 million and $11.7 million for the six months ended June 30, 2013 and June 30, 2012 , which primarily consisted of investments in learner success initiatives, academic quality, and foundational priorities. Capital expenditures in 2013 also included enhancements to our visitor center, and improved management of internal and external labor resources that support our overall strategic initiative investments.

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

Financing Activities

Net cash used in financing activities was $1.5 million and $25.2 million for the six months ended June 30, 2013 and 2012 , respectively. The decrease in net cash used is primarily the result of a reduction in repurchases of our common stock. In the first six months of 2013 , we repurchased $2.1 million of common stock under our repurchase program, excluding commissions. In the first six months of 2012 , we repurchased $25.5 million of common stock, excluding commissions.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Market Risk

The Company has no derivative financial instruments or derivative commodity instruments, and believes the risk related to cash equivalents and marketable securities is limited due to the adherence to its investment policy, which focuses on capital preservation and liquidity. In addition, all investments must have a minimum Standard & Poor’s rating of A minus (or equivalent) by at least one agency at the purchase date. All of the Company's cash equivalents and marketable securities as of June 30, 2013 and December 31, 2012 w ere rated BBB+ or higher by at least one rating agency. In addi tion, the Company utilizes money managers who conduct initial and ongoing credit analysis on its investment portfolio to monitor and minimize the potential impact of market risk associated with its cash, cash equivalents and marketable securities. Despite the investment risk mitigation strategies the Company employs, it may incur investment losses as a result of unusual and unpredictable market developments and may experience reduced investment earnings if the yields on investments deemed to be low risk remain low or decline further in this time of economic uncertainty. Unusual and unpredictable market developments may also create liquidity challenges for certain assets in the Company's investment portfolio.

Interest Rate Risk

The Company manages interest rate risk by investing excess funds in cash equivalents and marketable securities bearing a combination of fixed and variable interest rates, which are tied to various market indices. The Company's future investment income may fall short of expectations due to changes in interest rates or it may suffer losses in principal if it is forced to sell

securities that have declined in market value due to changes in interest rates. At June 30, 2013 , a 10% increase or decrease in interest rates would not have a material impact on the Company's future earnings, fair values, or cash flows.

Foreign Currency Exchange Risk

The Company uses the U.S. dollar as its reporting currency. The functional currencies of its foreign subsidiaries are generally the local currencies. Accordingly, the Company's foreign currency exchange risk is related to the following exposures:

- Adjustments resulting from the translation of assets and liabilities of the foreign subsidiaries into U.S. dollars using exchange rates in effect at the balance sheet dates. These translation adjustments are recorded in accumulated other comprehensive income;
- Earnings volatility translation of income and expense items of the foreign subsidiaries using an average monthly exchange rate for the respective periods; and
- Gains and losses resulting from foreign exchange rate changes related to intercompany receivables and payables that are not of a long-term investment nature, as well as gains and losses from foreign currency transactions. These items are recorded in other income (expense), net in the Consolidated Statements of Income.

The Company has not used derivative contracts to hedge foreign currency exchange rate fluctuations.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

The Company carried out an evaluation, under the supervision and with the participation of its management, including the chief executive officer and the chief financial officer, of the effectiveness of the design and operation of its disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act).

Based upon that evaluation, the chief executive officer and chief financial officer concluded that the Company's disclosure controls and procedures were effective, as of June 30, 2013 , in ensuring that material information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in reports it files or submits under the Securities Exchange Act is accumulated and communicated to management, including its principal executive officer or officers and principal financial officer or officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Control over Financial Reporting

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

PART II - OTHER INFORMATION

Item 1. Legal Proceedings

From time to time, the Company is a party to various lawsuits, claims and other legal proceedings that arise in the ordinary course of business. While the outcomes of these matters are uncertain, management does not expect that the ultimate costs to resolve these matters will have a material adverse effect on the Company's consolidated financial position, results of operations or cash flows.

Item 1A. Risk Factors

There have been no material changes to the risk factors disclosed in the “Risk Factors” section as updated in the Company's Form 10-K for the year ended December 31, 2012 .

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

Recent Sales of Unregistered Securities

None.

Purchases of Equity Securities by the Issuer and Affiliated Purchasers

During the three months ended June 30, 2013 , the Company used $2.0 million to repurchase shares of common stock under its repurchase program. [(1)] Its remaining authorization for common stock repurchases was $6.1 million at June 30, 2013 . The following presents the Company's share repurchases during the quarter ended June 30, 2013 :

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Dollar Value of Shares That May Yet be Purchased Under the Plans or Programs
4/1/2013 to 4/30/2013	500	$ 33.38	500	$ 8,128,234
5/1/2013 to 5/31/2013	48,200	38.93	48,200	6,251,754
6/1/2013 to 6/30/2013	2,345	46.79	2,345	6,142,041
Total	51,045	39.24	51,045	6,142,041

(1) The Company announced its current share repurchase program in July 2008. As of June 30, 2013 , the Company's Board of Directors has authorized repurchases up to an aggregate amount of $235.7 million in value of common stock under the current program. The Board of Directors authorizes the Company to repurchase outstanding shares of common stock, from time to time, depending on market conditions and other considerations. There is no expiration date on the repurchase authorizations and repurchases occur at the Company's discretion.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

None.

Table of Contents

Item 6. Exhibits

(a) Exhibits

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	Second Amended and Restated By-Laws.	Incorporated by reference to Exhibit 3.2 to the Company's Current Report on Form 8-K filed with the SEC on December 10, 2008.
4.1	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 Market Stock Unit Agreement (Section (16(B) Officer) under 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.
EX-101.INS	XBRL Instance Document [(1)]	Filed electronically.
EX-101.SCH	XBRL Taxonomy Extension Schema Document [(1)]	Filed electronically.
EX-101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document [(1)]	Filed electronically.
EX-101.DEF	XBRL Taxonomy Extension Definition Linkbase Document [(1)]	Filed electronically.
EX-101.LAB	XBRL Taxonomy Extension Label Linkbase Document [(1)]	Filed electronically.
EX-101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document [(1)]	Filed electronically.

(1) The XBRL related information in Exhibit 101 to this Quarterly Report on Form 10-Q shall not be deemed "filed" for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, or otherwise subject to liability of that section and shall not be incorporated by reference into any filing or other document pursuant to the Securities Act of 1933, as amended, except as shall be expressly set forth by specific reference in such filing or document.

SIGNATURES

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

CAPELLA EDUCATION COMPANY

/s/ J. Kevin Gilligan

July 23, 2013

J. Kevin Gilligan
Chief Executive Officer
(Principal Executive Officer)

/s/ Steven L. Polacek

July 23, 2013

Steven L. Polacek
Senior Vice President and Chief Financial Officer
(Principal Financial and Accounting Officer)

Exhibit 10.1

CAPELLA EDUCATION COMPANY
2005 STOCK INCENTIVE PLAN

Market Stock Unit Award Agreement Terms and Conditions

1. **Award Agreement .** These Terms and Conditions, together with the signature page to which they are attached, comprise a Market Stock Unit Award Agreement ("Agreement") between Capella Education Company, a Minnesota corporation (the "Company"), and the recipient identified on the signature page (the "Recipient"), effective as of the date of grant specified on the signature page (the "Grant Date"). 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, as amended (the "Plan").

2. **Grant of Market Stock Units** . The Recipient is hereby granted the number of market stock units ("Units") specified on the signature page to this Agreement.

3. **Vesting and Payment of Units** .

(a) *Number of Shares* . Subject to Sections 3, 4 and 5 of this Agreement, the number of Units subject to this Agreement that will vest on the Scheduled Vesting Date (as defined below) shall be a function of the Ending Value (as defined below) of the Company's common stock as of the end of the applicable Performance Period (as defined below) as set forth in the following schedule, provided the Recipient's employment with the Company does not terminate on or before the Scheduled Vesting Date. Any Units that do not vest on the Scheduled Vesting Date shall be forfeited.

Ending Value (1)	% of Units That Vest	# of Units That Vest

_____

(1) If the Ending Value is between two of the values shown in the table, then the number of Units that vest will be determined by straight line interpolation between the applicable Unit values shown in the table.

For purposes of this Agreement:

(1) The "Ending Value" shall be equal to the average of the closing prices of the Company's common stock on the Nasdaq National Market on the last ____ calendar days of the Performance Period, plus the sum of all regular and special cash dividends paid on a share of the Company's common stock during the Perforamnce Period.

(2) The "Performance Period" is the period from the Grant Date through the Scheduled Vesting Date.

(3) The "Scheduled Vesting Date" is _____, or such other date as contemplated by Section 4(c).

(b) *Payment* . Subject to Section 9, each vested Unit shall be paid and settled in one share of the Company's common stock. Issuance and delivery of Shares in payment of vested Units will occur within ten (10) days after vesting of the Units, and Recipient shall have no power to affect the timing of such delivery. Such issuance shall be evidenced by a stock certificate or appropriate entry on the books of the Company or a duly authorized transfer agent of the Company, and shall be in complete satisfaction of such vested Units. If the Units that vest and become payable include a fractional Unit, the Company shall round the number of vested Units to the nearest whole Unit prior to delivery of Shares as provided herein. If the ownership of or issuance of Shares to Recipient as provided herein is not feasible due to applicable exchange controls, securities or tax laws or other provisions of applicable law, as determined by the Committee in its sole discretion, Recipient or his or her Successor shall

receive cash proceeds in an amount equal to the Fair Market Value (as of the date vesting occurs) of the Shares otherwise issuable to Recipient in payment of vested Units, net of any amount required to satisfy withholding tax obligations as provided in Section 11.

(c) *Effect*. Whenever the Company shall become obligated to make payment in respect of a Unit subject to this Agreement, all rights of Recipient with respect to such Unit, other than the right to such payment, shall terminate and be of no further force or effect and such Unit shall be cancelled.

(d) *Payments on Death*. Any payment due under this Agreement following the death of Recipient shall be paid to the Successor of Recipient.

(e) Clawback. Notwithstanding anything apparently to the contrary herein, if the Board determines that Participant has engaged in business conduct inconsistent with the Company's ethical standards, including those ethical standards that apply to the Company's regulatory matters, then (i) if the Units have not yet been settled in shares of Common Stock, the Units shall be immediately and irrevocably forfeited without any payment therefor; and (ii) if the Units have vested and been settled in shares of Common Stock, Participant shall be required, upon demand, to repay or otherwise reimburse the Company an amount having a value equal to the aggregate Fair Market Value of the shares of Common Stock underlying such Units on the date the Units became vested.

4. **Effect of Termination of Employment**. If Recipient ceases to be an Employee prior to the Scheduled Vesting Date, the following provisions apply:

(a) *Termination for Cause*. If Recipient's employment is terminated for Cause (as defined in the Plan), Recipient shall immediately forfeit the Units.

(b) *Voluntary Termination, including Retirement*. If Recipient resigns or otherwise voluntarily terminates his/her employment, including for retirement at any age, Recipient shall immediately forfeit the Units.

(c) *Death, Disability or Termination without Cause*. If Recipient's employment is terminated as a result of Recipient's death or Disability (as defined in the Plan) or is terminated without Cause, then the Units shall immediately vest and be paid in Shares as provided in Section 3; provided, however, in such instance the date of death, Disability or termination without Cause shall be deemed the Scheduled Vesting Date.

5. **Change in Control**. If a Change in Control (as defined below) 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, 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, then all of the Units subject to this Agreement shall immediately vest and be paid in full as provided in Section 3(b).

For purposes of this Agreement, 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 6(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.

For purposes of this Agreement, "Good Reason" is defined as a material demotion or material 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, provided that none of these conditions shall constitute Good Reason unless Recipient first gives written notice to the Company within 90 days of the first occurrence of the condition, delineating the claimed breach and setting forth Recipient's intention to terminate Recipient's employment if such breach is not duly remedied within 30 business days, and the Company fails to cure the condition within such 30-day period.

6. **Adjustments for Changes in Capitalization** . The number of Units subject to this Agreement and the Ending Values and the numbers of Units specified in the table in Section 3(a) shall be subject to adjustments for changes in the Company's capitalization as provided in Section 16 of the Plan.

7. **No Transfer** . The Units may not be pledged, assigned or transferred except as expressly provided in Section 6.3 of the Plan.

8. **No Shareholder Rights Until Payment** . The Recipient shall not have any of the rights of a shareholder of the Company (including the right to vote and receive dividends) in connection with the award of Units subject to this Agreement unless and until Shares are issued to him/her upon payment of the Units.

9. **Forfeiture Events .**

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

(1)perform services for any Competitor 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 Recipient became aware of or were introduced to in the course of 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 Recipient's employment that violates the Company's codes of conduct or other policies.

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

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

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

(c) The foregoing remedies set forth in Section 9(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 provide notice of its determination and forfeiture of Units within ninety days after discovery of such an occurrence but in no event later than fifteen months after Recipient's termination of employment with the Company.

(e) For purposes of this Section 9, the following terms shall have the meanings set forth below:

"Competitor" means any person, corporation, not-for-profit organization or other entity that is engaged in any business that competes with: (a) any of the businesses or programs conducted by the Company during the term of Recipient's service with the Company, or (2) any of the potential businesses or programs Recipient knew or had reason to know were in development by the Company in the education industry during the period of Recipient's service with the Company.

"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 Recipient or to which Recipient obtains access, whether originated by Recipient or by others, during the period of Recipient's employment, shall be presumed to be Confidential Information if it is treated by the Company as being Confidential Information or if Recipient has a reasonable basis to believe it to be Confidential Information.

10. **Discontinuance of Employment .** This Agreement shall not give 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 Recipient may terminate his/her employment at any time and otherwise deal with Recipient without regard to the effect it may have upon him/her under this Agreement.

11. **Tax Withholding** . As a condition precedent to making a payment hereunder, Recipient shall be required to pay to the Company (or the Subsidiary or Affiliate employing Recipient), in accordance with the provisions of Section 14 of the Plan, an amount equal to the amount of any required domestic or foreign tax withholding obligation, including any social security obligation. The Company (or the Subsidiary or Affiliate employing Recipient) may withhold Shares equal in value to the amount of such tax withholding obligation, or may permit Recipient to arrange for the satisfaction of such tax withholding obligation by payment of the estimated tax obligation to the Company (or the Subsidiary or Affiliate employing Recipient). Payment may be made by electronic transfer, check or authority to withhold from salary.

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 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 .** Recipient acknowledges that the Units 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 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).

16. **Section 409A of the Code** . The provisions of this Agreement shall be interpreted and construed in a manner intended to comply with Section 409A of the Code, the regulations issued thereunder or any exception thereto. Each payment under this Agreement is intended to be excepted from Section 409A under the short-term deferral exception as specified in Treas. Reg. § 1.409A-l(b)(4).

Exhibit 31.1

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

CERTIFICATION OF CHIEF EXECUTIVE OFFICER

I, J. Kevin Gilligan, 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)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) 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) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
    c) 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
    d) 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: July 23, 2013

/s/ J. Kevin Gilligan

J. Kevin Gilligan
Chief Executive Officer

Exhibit 31.2

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

CERTIFICATION OF CHIEF FINANCIAL OFFICER

I, Steven L. Polacek, 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)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) 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) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
    c) 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
    d) 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: July 23, 2013

/s/ Steven L. Polacek

Steven L. Polacek
Senior Vice President and Chief Financial Officer

Exhibit 32.1

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 June 30, 2013 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, J. Kevin Gilligan, 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/ J. Kevin Gilligan

J. Kevin Gilligan
Chief Executive Officer
July 23, 2013

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.

Exhibit 32.2

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 June 30, 2013 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Steven L. Polacek, 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/ Steven L. Polacek

Steven L. Polacek
Senior Vice President and Chief Financial Officer
July 23, 2013

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.