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LRN - Q3 2014 K12 Inc. Earnings Conference Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the K12 third-quarter earnings conference call. My name is Wanda, and I will be your coordinator for today. (Operator Instructions). As a reminder, this conference is being recorded for replay purposes.

I would now like to turn the conference over to your host, Mr. Mike Kraft, President of Investor Relations. Please proceed, sir.

Mike Kraft *- K12 Inc. - VP, IR*

Thank you and good morning. Welcome to K12's third-quarter fiscal 2014 earnings conference call.

Before we begin, the Company would like to remind you that statements made during this conference call that are not historical facts may be considered forward-looking statements made pursuant to the Safe Harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements involve risks and uncertainties that could cause actual events or results to differ materially early from those expressed or implied.

In addition, this conference call contains time-sensitive information that reflects management's best analysis only as of the date of this live call. K12 does not undertake any obligation to publicly update or revise any forward-looking statements. For further information concerning issues that could materially affect the financial performance related to forward-looking statements, please refer to our filings with the SEC. These files can be found on the Investor Relations section of our website at www.K12.com.

In addition, disclosing results in accordance with Generally Accepted Accounting Principles in the US, or GAAP, we will discuss certain information that is considered non-GAAP financial information. A reconciliation of this non-GAAP financial information to the most closely comparable GAAP information was included in our earnings release and is also posted on our website.

This call is open to the public and is being webcast. The call will be available for replay on our website for 60 days.

With me on today's call is Nate Davis, Chief Executive Officer and Chairman; Tim Murray, President and Chief Operating Officer; and James Rhyu, Chief Financial Officer. Following our prepared remarks, we will answer any questions you may have.

I'd like to now turn the call over to Nate. Nate?

Nate Davis - *K12 Inc. - Chairman and CEO*

Good morning, everyone, and thanks for joining us on the call today. As you saw in our release this morning, we delivered solid results for the third quarter. Revenue was $235.2 million, increasing 7.9% year over year, and our operating income was $27.4 million, increasing 41.2% year over year. Both revenue and operating income were well within the line -- in line with the guidance we provided last quarter.

This performance is a result of our strategy to have a better balance between growth and profitability. To get this balance, we instilled more discipline in the assignment of resources. But I want to be clear that we will continue to invest in the content, systems, and tools our students and teachers need. We won't slow down our investment in a better quick human better systems.

Going forward, we believe our growth will come from increasing enrollment in our current schools; developing new counties, as we announced last quarter with the two new public charter schools in Florida; and by opening new schools within our current state footprint. While I also believe we will see growth in the new states, it will not be at the pace we've seen in previous years.

Speaking of new schools in existing states, this quarter I am pleased to announce that a new K12 managed public school will be opening in Michigan. This will be a K12 Insight school, and it will focus on at-risk students from across the state. The school will have a first-year capacity of 2,500 students and will increase to the capacity of 10,000 students by year three. We're very excited about the opportunity to bring more choice to the families in Michigan and tentatively scheduled to open the school in the fall of 2014.

In addition, the Iowa Virtual Academies has just announced a collaboration with the Northeast Iowa Community College in the Association of Business and Industry. This new endeavor will provide an advanced manufacturing program for high school students. This is a three-year blended program with online instruction being complemented with on-site workshops and engage in local businesses to ensure that the skills taught match the needs of employers. Creating a direct path to either a job or a technical college program right after graduation is just one of the many ways we will look to create pathways that are relevant to students and attract them to K12 managed public schools.

Look for us to continue to explore ways to engage students in learning, including developing similar career technical education programs in other states.

I now want to say a few words about our core mission: helping students achieve the best possible academic outcomes. Last month we were proud to host our second Academic Day where our teachers and school leaders shared our progress, our challenges, and our approaches to educating the students. The data we shared was also published in our latest academic reports. The key findings that are shared were as follows.

First, a higher percentage of K12 students are eligible for free or reduced lunches than most schools. In fact, 63% of our students are eligible for free and reduced lunches compared to 49% nationally. As is true across the nation, students who are eligible for meal subsidies tend to academically underperform those who are not eligible. This translates into academic performance of students at K12-managed schools that are generally below the performance of students in traditional schools.

Second, students in K12-managed schools have shown higher proficiency in reading than in English language arts or in mathematics. Proficiency equates to the percent of students above a cut score on a state annual assessment test. These tests are state-specific and administered to all public schools. The cut score that I mentioned, in fact, constitutes the passing score on a test.

On these assessments in the spring of 2013, 69% of our students were proficient in reading, 66% proficient in English language arts, and 47% proficient in mathematics.

And third, perhaps the most important on the effectiveness of our program, persistence makes a difference. Data confirms that students perform better on state assessment tests the longer they stay with the K12 program. Students enrolled three or more years in K12 managed public schools achieved higher proficiency compared to students enrolled less than one year, and in fact, 17% higher in reading, they were 19% higher in English language arts, and 22% higher in mathematics if they stayed three years.

While we are making improvements, we know more must be done to achieve better academic results. We are committed to continual improvements and enhancements to our academic programs and curriculum to serve all types of students, our high achievers and our academically at risk. We are committed to refining our systems and technology to meet the needs of all students and providing teachers the tools and resources they need to be effective. Our students and our schools remain our top priority.

Now before I hand the call off to Tim Murray, who will provide you highlights of our operations, I wanted to mention that during the third quarter we decided not to pursue our previously announced intent to create a new company with Safanad, due to the complexities of the transaction. However, we will continue to evaluate strategic options relative to the possible sale of one or more of these assets, including discussions with Safanad themselves.

Thank you very much, and now let me turn the call over to Tim. Tim?

Tim Murray *- K12 Inc. - President and COO*

Thanks, Nate, and good morning to everyone.

Overall, I'm very pleased with our progress this quarter, and I will focus my remarks on two topics: first, the investments we continue to make in our students and teachers, and second, our continued progress in improving our enrollment and marketing effectiveness.

This quarter we continue to evolved our data-driven instructional model in our schools using informative assessment data to target instruction and remediation for students. Teachers continued working in professional learning communities, or PLCs, as we call them, to study school data, formulate action plans, and share best practices for student engagement and learning. In late February, 40 of these school leaders joined corporate and regional staff at K12 headquarters to begin planning for the new school year starting in the fall.

During the quarter, we also began to implement state-specific testing across our Managed Public Schools, which are continuing into this quarter, the fourth quarter. At least two of the schools we manage are helping to field test the new Smarter Balanced Assessment Consortium, or SBAC for short, the common core aligned assessments.

New course options were also introduced this quarter as we brought to market new content and capabilities for all grade levels. As part of this effort, we more than doubled our mobile portfolio with new capabilities, including Embark Mobile Companion application for pre-K and kindergarten students and some 2,000 new applications on tablets for advanced placement exam preparation. These are just a small example of our overall effort to transform our offering to be more mobile ready. Mobile is an increasingly important part of how students want to engage. We will continue to transition our content to be device agnostic as we balance our pace with the declining unit cost of content conversion.

For all the effort our educators and developers put into our educational solutions, I am proud to say that others in the industry are recognizing their hard work. This quarter, K12 Solutions received a number of awards, including the Parents' Choice Award, which honors the best material created for children. K12 was an award winner for its Embark Online and Noodleverse educational offerings and for its K12 Timed Reading & Comprehension Practice mobile application.

The CODiE Award, which is a peer-recognized program for content, education and software, is truly a market validation of a Company's product innovation, vision and impact. K12's EmbarK Comprehensive was a finalist for Best Cross-Curricular Solution for Education.

And finally, the EdTech Digest Cool Tool Award, which recognizes new, emerging, and established technology solutions for education.

K12's Forensic Science was a finalist for STEM solutions, our Algebra 1 was a finalist for e-learning and math, and our CHALK IT UP! application was a finalist for the Elementary Mobile Solution. These awards are just another validation that we are focused on creating great content in platforms that support our students to achieve stronger academic outcomes.

As for the student experience, we achieved system-wide performance of 99.4% availability in the quarter for our learning management platform and 99.7% for our PEAK solution for school districts in the quarter.

Now let's switch gears to review the progress with our enrollment process and marketing efforts.

For our go-to-market approach, we tested a number of new creatives with the ultimate goal of attracting more students who will be successful within our educational model. New television ads are in market being tested in several markets across the US. Early results indicate several of the creatives outperform our ads for last year. We've also implemented a more holistic approach to track our progress from media acquisition through student interest and application all the way to enrollment. This new model will help us track marketing enrollment performance against our goals as well as further optimize our costs.

And we are on track with implementation of the initiatives I referenced on our last call. We have implemented our national enrollment center model, reduced the number of call-handling queues from 16 to five. This provides us greater flexibility into service changes in our demand profile.

We went live with our current portal, which fundamentally redesigned the application process and reduces the enrollment steps while providing the family much better information and control over the enrollment process.

We have introduced the ability for families to scan and upload documents required for enrollment, addressing a very significant pain point from prior seasons.

And we are now live and operational on our own cloud-based telephony platform, improving our management of inbound calls. And last, we have announced the opening of our new family support center in Knoxville, Tennessee. We expect to open in late May with an initial team size of 125 employees growing to 300 over time.

Our goal continues to be to build a marketing and enrollment team that can effectively identify and attract students who will thrive and succeed within the online curriculum option provided by K12. While we're off to a good start, building a fully accountable end-to-end marketing enrollment capability is an ongoing process. The efforts above clearly represent improvements, but we still have work to do. I will plan to provide updates on our progress during our future earnings calls.

Thanks very much, and I will hand the call over to James.

James Rhyu - *K12 Inc - EVP and CFO*

Thinks, Tim, and good morning, everybody.

As Nate already mentioned, revenue and operating income for the quarter were in line with our guidance. I will go through the details with you in a minute, but we were generally pleased with the results this quarter.

In addition, we generated $46.6 million in free cash flow and held our cost structure in line with our expectations. At the same time, we continue to invest in academic outcomes and will continue to make these investments going forward, as Nate mentioned.

Now let me take you through some details of the quarter. Revenue for the quarter was $235.2 million, an increase of 7.9% over the year-ago quarter. This growth was largely driven by an increase of 9% in our managed public schools revenue and is consistent with the trends we saw last quarter. Enrollments rose 5.3% year over year, while average rate per enrollment rose 3.6%.

Institutional sales revenue decreased $2.2 million or 13.9% from the prior year. The sequential decline is consistent with the seasonal trend we saw last fiscal year.

Our international and private pay schools revenue increased $2.2 million or 20%. Total semester course enrollments rose by 10%, and student enrollments rose by 12%, associated with strong spring enrollments.

Gross margins declined from 41.4% last year to 40.2% this year. However, on a sequential basis, gross margins were relatively flat to Q2. We would expect to see gross margins at around this level on a full-year fiscal basis.

Selling, administrative and other expenses declined slightly to $64.4 million on a year-over-year basis. Sequentially, expenses rose 2.7% if you exclude the $32.2 million of charges incurred in the second quarter, $13 million of which hit this line item. This increase is due to some seasonality and expenses as we plan for the upcoming enrollment season. We have indicated previously that we would be starting these activities earlier in the year, and you will also see further increases going into the fourth quarter.

Product development expenses for the quarter were $2.8 million versus $5.1 million in the prior year. As we mentioned last quarter, this decline is primarily a result of the greater focus on resources on new project initiatives and an improved operating efficiency in our model. I would expect these expenses to remain consistent with Q2 and Q3 levels through the end of the year.

Operating income was $27.4 million, equating to an operating margin of 11.6%. Operating income grew $8 million or 41.2% versus last year. Seasonally, this has been the strongest quarter for us for the past few years, but we still saw some margin expansion on a year-over-year basis. On a sequential basis, excluding the charges in Q2, operating income grew $4.1 million or 17.6%.

Now let me turn to some other items. We ended the quarter with cash and cash equivalents of $185.3 million, an increase of $28.4 million from the prior year and relatively flat from the prior quarter and from the first quarter of the current fiscal year. This quarter included over $20 million of share repurchases.

Net cash provided by operating activities for the nine months of the year was $81.5 million, up $22.3 million from the year-ago period.

Accounts receivable remained largely unchanged compared to the prior year, and DSOs were marginally better this quarter.

The Company repurchased over 958,000 shares of common stock at a total cost of $20.7 million. We have $48.4 million remaining available under authorization in our share repurchase program, and we will continue to monitor the progress of this program.

CapEx, as we have historically defined it, which includes curriculum and software development, computers and infrastructure, was $14.3 million for the quarter compared to $16.4 million in the prior year. The decrease is largely due to some timing of investments in student computers year over year.

Our tax rate for the quarter was 43% compared to 40% in the year-ago period due to the impact of some foreign operations and some permanent differences between booked and tax deductions. We still think we will end the year with an effective tax rate between 40% and 42%, which is consistent with our guidance at the beginning of the year.

Turning to expectations for the fourth quarter, we expect revenue of $217 million to $227 million; operating income of between $10 million and $15 million; capital expenditures of $20 million to $25 million. This equates to full-year revenue guidance in a range of $905 million to $915 million and operating income on a recorded basis of $21 million to $25 million, excluding the impact of the $32 million in charges in the second quarter. The full-year operating income is expected to be in a range of $53 million to $57 million, which would also exclude the impact of any charges associated with the contemplated transaction.

Both revenue and operating income are consistent with our full-year guidance.

With that, I will hand the call back over to Nate.

Nate Davis - *K12 Inc. - Chairman and CEO*

Okay. Thanks, James. Thanks, Tim. Operator, I think we can move into questions now.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Corey Greendale, First Analysis.

David Warner - *First Analysis - Analyst*

This is David Warner for Corey. I just wanted to ask you about selling and administrative expense. Would you expect with a lot of the enrollment process changes that you implemented that you would expect more of that expense to maybe shift seasonally into Q4 versus Q1, and then what are your expectations for selling and administrative expense in 2015?

James Rhyu - *K12 Inc - EVP and CFO*

We certainly expect some seasonal tick up in Q4. We're not really talking about 2015 yet, so not really going to give an indication of where we are going to be for 2015 at this time. We're going to invest early, which we have started to do already, as I mentioned, but no indication on 2015 at this time.

David Warner - *First Analysis - Analyst*

And then just shifting gears, what are your expectations for revenue per student or just maybe the funding level in general for 2015 in the managed school business, managed public school business?

Nate Davis - *K12 Inc. - Chairman and CEO*

I think we are -- again, James said we are not giving any guidance for next year, but I will just tell you, trending wise, we don't see the trend changing from what happened this past year. We expect the revenue per student to be relatively small increases. But everything is on a by state basis for K12. So in one state we may see an increase of $200, $300 a student; in another case, we may see it go down a little bit.

Overall, when you average across all states, I think it will be a small increase in revenue per student.

James Rhyu - *K12 Inc - EVP and CFO*

It depends on the mix of enrollments we achieved at the end of the season.

David Warner - *First Analysis - Analyst*

Got you. And then just one real quick one on the institutional business revenue, it was down on an easier comp year over year. Was there any lumpiness as far as license sales or anything there where you saw maybe fewer big transactions, anything like that, or is that a reflection of the underlying where that business is right now?

James Rhyu - *K12 Inc - EVP and CFO*

I think right now again we mentioned that that business is in a little bit of transition. I think you saw last year a very similar sequential decline in absolute dollar amount. I think actually the numbers were very close in sequential declines. We continue to assess this business to make sure that we're going to market in an appropriate way. We are very committed to this business, and we continue to invest in it. But like I said, this is a business in transition for this year.

David Warner - *First Analysis - Analyst*

All right. Thank you.

Operator

Jeff Meuler, Baird.

Jeff Meuler - *Robert W. Baird - Analyst*

In terms of the initial response rates to the TV ads, I think you called them out as favorable, but I didn't know exactly what you mean by that. Are you talking number of inquiries, quality of inquiries? What exactly are you guys seeing?

Tim Murray - *K12 Inc. - President and COO*

Jeff, it is Tim. What we can initially measure at this early stage of the test is the response, the lead response from the advertisements themselves. And that is what specifically I was referring to when I saw some improvements over our prior ads from last year.

Jeff Meuler - *Robert W. Baird - Analyst*

Okay. And what are you guys --

James Rhyu - *K12 Inc - EVP and CFO*

Just to be clear, those ads that Tim referred to, they were tested in select small -- in select markets. So it wasn't a national test. It was a small program, so that was just an early indication. I think he mentioned that earlier, just to be clear.

Jeff Meuler - *Robert W. Baird - Analyst*

Okay. Thank you. And then what are you guys budgeting for marketing spend this enrollment season versus last enrollment season?

James Rhyu - *K12 Inc - EVP and CFO*

Again, we are not giving any indications for 2015. I think we're certainly investing earlier, and we haven't finalized the process of what the full enrollment season investment is going to be.

Nate Davis - *K12 Inc. - Chairman and CEO*

Across the full enrollment season, not the total dollars won't be significantly different. It will just be more of it earlier in the year, as James mentioned. So we will see more in the fourth quarter than we would normally have seen in the first quarter. But as we go through the year, we also may continue to adjust as we see the market react to our promotions.

Jeff Meuler - *Robert W. Baird - Analyst*

Okay. And then could you just help us with the product development expense line item? I know that it was down last quarter, and you said you expect it to be down again on a year-over-year basis this quarter. But just trying to sync up your comments about investing in academics, and what is driving such a sizable year-over-year decline in the product development expense line item?

Tim Murray - *K12 Inc. - President and COO*

Jeff, it is Tim again. The mix of the nature of the products we are completing and whether that project is capitalized or expensed is probably the biggest contributor here.

If we look at our investment on a cash basis, you would see that it has been fairly consistent period to period.

Jeff Meuler - *Robert W. Baird - Analyst*

Okay. Thank you.

Operator

Jeff Silber, BMO Capital Markets.

Jeff Silber - *BMO Capital Markets - Analyst*

Was wondering if we can get a little bit more color in terms of your decision not to spin off the businesses to Safanad. If you can just -- you mentioned some of the complexities, but if we can get a little bit more detail, that would be great.

Nate Davis - *K12 Inc. - Chairman and CEO*

Jeff, it is Nate. Well, first, it wasn't so much spinning them off to Safanad. Remember, it was going to be a joint venture. We would have some percent ownership, and they would have ownership, and we were going to be partners in it. The nature of the complexities centered around all the rules to try to set up when you set up a partnership: who does what, who's going to do what in what particular markets, and all the -- lots of rules got into negotiation. It just became a more complicated arrangement than we wanted it to be, which is why we, I said, will look at perhaps selling some of the assets. And we will talk with Safanad, and we will talk with others. But I think a cleaner sale, I mean the sale is in a cleaner position than a joint venture was.

I'd rather not go into all the details of a negotiation, but I can tell you it is centered around all the operating agreements that had to be set up, the licensing agreements that had to be set up. It just ran into too many complications.

James Rhyu - *K12 Inc - EVP and CFO*

And remember, part of the objective of the transaction was, in fact, to reduce some of the complexity and distraction within our business, and as we got into it, I think everything that Nate mentioned we realized that it was going to potentially increase it. So I think strategically for us we wanted to make sure that we held true to the strategic objective of the contemplated transaction.

Jeff Silber - *BMO Capital Markets - Analyst*

Okay. Great.

In your remarks, you talked about the new Insight School, and you mentioned the focus on average students. Can you remind us, is that the way that Insight School is being marketed more towards average students?

Nate Davis - *K12 Inc. - Chairman and CEO*

Most Insight Schools are, but not all. We have some Insight Schools that are really what I would call normal schools. They are marketed toward high achievers. They are marketed toward an average student. But most of our Insight Schools, yes, we try to target for average students. That is the general nature of the program. It has a different instructional model. It has more teacher time and more involvement, so we try to gear that program toward those students that are a little further behind.

Jeff Silber - *BMO Capital Markets - Analyst*

If I can just sneak in one follow-up question, I know in the past you've talked about and Ron had talked about some of the focus on special education students. If you can remind us what percentage of your students you would classify in that category. I don't know if you have the information on maybe the number of students that have IDPs, and is this going to be a continued focus for the Company?

Nate Davis - *K12 Inc. - Chairman and CEO*

Under the definition that the educational industry and federal government uses, we are a little over 10%. I think we're like 11%, 12%, right in that kind of range for special education students. And I'm sorry, Jeff, what was the second part of your question?

Jeff Silber - *BMO Capital Markets - Analyst*

Yes, I was just wondering, is this going to be a continued focus for the Company?

Nate Davis - *K12 Inc. - Chairman and CEO*

Absolutely. We have talked many times about as a public school we take on all kids who apply, make it through the process and the parents decide this really is a good program for them. And to the extent they are special education students, if they get through that process, we want to serve them. We think they are an important market, and so we will continue.

I don't think the number is going to decline in percent. I think you may see it actually go up a little bit or stay flat. But yes, it will remain a key focus for us.

Jeff Silber - *BMO Capital Markets - Analyst*

And on a revenue-per-student basis, is it safe to assume that the revenue per student is higher for those students than it is for the general population?

Nate Davis - *K12 Inc. - Chairman and CEO*

It is a different funding model is a better way to say it than to say it is higher. It's a different funding model, also a different expense model. Because remember the special education teachers, you have a different student-teacher ratio. You have special tools you have to provide. So it's different from the model because some of it comes from the federal government as opposed to all of it coming from the state. So I wouldn't call it higher. I would just say different sources of funding.

Jeff Silber - *BMO Capital Markets - Analyst*

All right. Great. Thanks so much. It is very helpful.

Operator

Jerry Herman, Stifel.

Jerry Herman - *Stifel Nicolaus - Analyst*

I just wondered if you would spend a minute on the NCAA situation and what sort of impact that might have on volume.

Tim Murray - *K12 Inc. - President and COO*

Jerry, it is Tim. We are working very, very hard with the NCAA to work with them to shape the policies for them to be able to ensure that their mission of ensuring eligibility for the schools that they regulate can be implemented in an online model. It was unfortunate that they took the action they recently did.

In terms of the impact on us, to be honest with you, it's not great in terms of absolute numbers of students, but from a marketing perspective, we would prefer not to be signaled out as a company who can support those kinds of students, even though it is a small number of students for us.

So it's not as much about a financial impact. It is more about us being able to serve the students that really do need our model, including those students who want to go on to Division 1 or Division 2 athletic programs.

Jerry Herman - *Stifel Nicolaus - Analyst*

Okay, great. And maybe can you guys talk -- I know it's still maybe a little bit early, but can you talk about the business development pipeline generally. You mentioned Michigan. I do have a question about Iowa in terms of how sizable that might be, but likewise, can you also address other states where you see opportunity in this season? And likewise, maybe spend a minute on Pennsylvania as we move into the potential renewal on that contract?

Nate Davis - *K12 Inc. - Chairman and CEO*

So remember, first of all, we talked last call about Hillsborough and Pinellas counties. Both counties are big counties in Florida. Those are probably the largest new schools that we're going to see in terms of immediate impact. I mentioned Michigan this morning. The Idaho College of Career Readiness Academy also opens this year. We have a small county in Florida, Clay County, that also opens in Florida this year. I mentioned the Iowa Virtual Academy.

So there is a number of schools coming on this year. I think you will continue to see us do more of that. There is possibilities for these states. We continue to work with regulators and policymakers in the states you have heard us talk about for a long time, but there's no promises in those states. I am talking about obviously states like North Carolina or New Jersey or something in Illinois. But there are no imminent openings coming in those states. Those are just states where we know there are potential discussions going on.

So the pipeline, I think if you look across the states, we're going to see more states where we will see opening of these career technical education. I think that is probably one of the most exciting things that we're doing, and we've got some people that are dedicated to having these conversations in other states.

I don't want to preannounce a state because, obviously, as we work with a particular state and work with a particular organization and before applications go in, a lot of discussions have to happen, and I don't want to damage a negotiation by announcing a negotiation-like sports organization can do sometimes. But I can tell you that we have at least three states that I know of that we're having a lot of conversation about career technical education opportunities today.

So I think you will see that. I think you'll see more Insight Schools. And I think you will see us continue to push for opening up new states. But, as I mentioned in my comments, I don't think the new states are going to be largest in the volume of them, but they are important so we continue to push for them.

Jerry Herman - *Stifel Nicolaus - Analyst*

How about PA, Nate?

Nate Davis - *K12 Inc. - Chairman and CEO*

I'm sorry. What was your question about PA?

Jerry Herman - *Stifel Nicolaus - Analyst*

Just any color on either the discussions you are hearing in that state. I mean typically at this time of year you get some rhetoric out of the legislature and likewise how you are positioning for that renewal.

Nate Davis - *K12 Inc. - Chairman and CEO*

Yes, Jerry, good question.

First of all, remember that there has been -- this legislation that was proposed earlier in the year in Pennsylvania that everybody was concerned that that was going to cause a big problem and reduce the funding. I think you will see something perhaps go through. But it really is an adjustment to funding and how some potential things are handled, but we don't see a major adjustment in the way Pennsylvania is going.

Again, these kind of things are things you don't want to get on a national call and try to get one way or the other because, obviously, this call with lots of people like regulators listening, and so they decide they are going to make a decision.

But I think there is less impact than everybody who was worried about it in the very beginning. As we're talking through with legislators and others, the parents all get involved. So I don't see a major funding change in Pennsylvania although we may see small funding changes.

I think we will always see some of that. In terms of our own school, as everybody knows, in the next year, year and a half, we will have -- actually we will file this year and next year in 2015, and then we will seek an approval for our Agora school. That approval is something we continue to work on. We negotiate a new service contract, and then they will get a charter renewal process going in the state of Pennsylvania, as well.

We watch what others are doing as they go through the process and make sure that our service contracts will be compliant with everything that the state wants. I think we are a good partner for Agora, and I think they are happy with what we have done. But we will always have to tweak and adjust the contracts as we go forward as the state regulators ask for different things. We have seen that in every other state. I have no reason why we wouldn't see some small changes in Pennsylvania, as well.

Jerry Herman - *Stifel Nicolaus - Analyst*

And you guys were helpful in the past talking about the contribution of revenue and operating losses in this case, the businesses that were going to be a part of the JV. Can you just reframe those metrics, if you will, on a revenue NOI basis?

James Rhyu - *K12 Inc - EVP and CFO*

I think we gave some indication previously that the revenue in fiscal year 2013 of those combined businesses were a little more than $20 million of revenue, and they contributed a few million dollars of operating losses. Those businesses actually have trended slightly better than that in this fiscal year. We don't break those results out in our financials, but they have grown our top-line, and they have, in aggregate, have shown losses. So you can think of it as a slight improvement to fiscal 2013 numbers.

Jerry Herman - *Stifel Nicolaus - Analyst*

Great, guys. Thanks very much. I will turn it over.

Operator

Sara Gubins, Bank of America Merrill Lynch.

Unidentified Participant

This is actually (inaudible) calling in for Sara Gubins. I just have one question right now for Tim Murray.

In your recent Academic Day, you talked about the improvements to the onboarding process to make it easier for parents to sign up. Are you seeing any early improvements in demand as a result? Thanks.

Tim Murray - *K12 Inc. - President and COO*

Thank you. It is a great question. We are seeing operational improvements in terms of the time with which a family can progress through the process. I can't correlate that to how that impacts demand, which is what I think your question was. All those improvements were meant to make it easier for a family, i.e., less friction to go through the enrollment process, and the metrics we are observing would suggest that we have reduced the amount of friction. But it is still early, and we're not being tested at high volume at this point in time. But we are encouraged by the results.

Nate Davis - *K12 Inc. - Chairman and CEO*

And when you say reduce the amount of friction, Tim, we have seen the amount of time it takes a parent to get through the application process. Just the early part of the process --

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Tim Murray - *K12 Inc. - President and COO*

Correct.

Nate Davis - *K12 Inc. - Chairman and CEO*

-- is shorter. Now, they still have to have conferences with our enrollment center for personnel. They still have to go through all the documents with the states. But just logging onto our system and getting that application in is taking less time than it ever took before.

Unidentified Participant

I see. Okay. Thank you. So just one more question. So can you comment on the legislative and competitive environment in managed public schools, and specifically in what states are you seeing a more difficult legislative environment? Thanks.

Nate Davis - *K12 Inc. - Chairman and CEO*

Legislative is a large word, and so let me talk about what we are seeing. I think all of our Boards of Education in all of the states want to make sure that the boards themselves are independent, the boards make the decisions about the direction of the school and that we are the provider of the curriculum but we are not in the operating school, but we do not make the decisions about the direction. And I think there is more focus on that from all of the regulators and the policymakers. They want to know that the boards own the academic results.

And so while we are there to support them, as a matter of fact, I was just with one of my boards yesterday morning, and in that breakfast meeting I had with them, they went through their process that they had gone through with the authorizer and what the authorizer has asked them to do. And clearly they are being held more accountable for student results.

So, as we talk about being held more accountable for student results, I think all of our boards are seeing the same thing, and that is what policymakers are all looking for.

And I think some of the resistance you have seen to new states opening up has been just all wanting to make sure that students are getting the best education they can. We want it, the regulators want it, the policymakers want it, and the boards do. And I think that is probably the biggest thing.

It is no longer about rate -- three years ago, two years ago, it was all about cutting rates, cutting rates, cutting rates and because the states were faced with terrible budget situations and a tough economy. Now they have gotten through that process, and now they have said, all right, virtual schools have been around long enough, let's make sure we're focused on the academic results. That is really the kind of environment. I hope I answered your question.

Unidentified Participant

You did, yes. Thank you. And just one more thing on the competitive environment. I know that there is a generally more accepted trend to have more technology in the classrooms, so are you seeing higher competition or any color you can provide would be helpful. Thanks.

THOMSON REUTERS

Nate Davis - *K12 Inc. - Chairman and CEO*

The competition we see is not competition for a school board to decide they have got to go to another provider. So we're not seeing as much of a competitive issue there as we are when new schools are opening, obviously, boards are deciding which provider they are going to use. And, most importantly, we are seeing our boards pressure us. And, by the way, we have the same desires we talked about before to look at alternative ways of providing the curriculum. Not just building it ourselves, but can you buy it. Can you buy a math course? Can you buy a reading remediation tool? Can you buy a testing tool or an assessment tool?

We are seeing greater availability of different kinds of tools piecemeal. We, of course, have to be a provider from kindergarten all the way up to 12th grade for the entire curriculum for all the subjects. So we don't see anybody else providing a full curriculum.

But what we do see are piecemeal solutions, and so we had to decide ourselves if we want to take individual parts of the piecemeal solutions. For example, should we be focused on math and reading and use somebody else's science course. And that is what -- I wouldn't call that competition in all cases. I would actually -- Tim and I are familiar with a word called co-opetition -- that means sometimes they are competitors when we look in the tool-led business, and other times they are providers to us because we can take those new tools and we can put them in our curriculum.

Unidentified Participant

Okay. All right. Thanks for the color.

Operator

Suzi Stein, Morgan Stanley.

Suzi Stein, Morgan Stanley.

Suzi Stein - *Morgan Stanley - Analyst*

You commented about the capacity you're adding in Michigan. Can you just give us a sense of the capacity that you're adding in the two Florida schools?

Nate Davis - *K12 Inc. - Chairman and CEO*

The Florida schools don't have a cap as you would think of it. So within the two counties they are, they are essentially uncapped. Now, we can talk about how many eighth-graders or seventh-graders live in a district. That's really -- it's really capped by how many people are in a district. And those are pretty large counties. I think we mentioned before that there's 200,000 school-aged students in Hillsborough County, and I think it's another 100,000 in the Pinellas County. So those are very large school districts. But there's not a cap on it; it's a matter of how many students decide to go with online education.

Suzi Stein - *Morgan Stanley - Analyst*

Okay. And just given that you're not pursuing the joint venture, can you just talk about how those assets are being run in the meantime as you're sort of figuring out what to do with them?

Nate Davis - *K12 Inc. - Chairman and CEO*

Sure, Suzi. There's really no change in how those assets are run. Each one has somebody who is leading the business. And, for example, a guy who leads the CapEd business is continuing to go out and pursue business. It reports into an executive who reports into me. So the [IC Burns] school or CapEd school or CapEd business or any of the other businesses we're talking about all basically report up to me. So they're not in the managed schools area. They're not in the finance area. They're all separate businesses that report into me.

Suzi Stein - *Morgan Stanley - Analyst*

Okay. And then just in terms of the institutional sales business, I know that you're not giving guidance for next year, but what are you expecting just in terms of this business kind of turning in terms of performance?

Tim Murray - *K12 Inc. - President and COO*

Well, Suzi, as you note, we're not giving any guidance about next year. But what we'll continue to do is invest in the platform. This is a business that is transitioning from what was largely a content business -- go out and sell catalog -- where now we believe it's important to sell the platform that makes it easy for the user to consume that catalog. So we'll continue to invest in the platform. We'll continue to invest in our own content. We'll continue to invest in the ability to integrate with third parties, to be able to bring their content to our customers. And we'll continue to address the workflow and complexity issues of our customers.

All while that's happening, we continue to see the revenue quality improving. Our percent of revenue as a proportion based on perpetual licenses has continued to decline, as we'd previously said it would. We're now at a point where the majority of our revenue is now based on either enterprise license sales or per-user sales, so a more predictable, certain type of revenue structure. And importantly, that's geared toward the way these customers want to buy. Districts want to be able to buy with certainty and predictability around what their costs are going to be. And so we've conformed to that.

So we'll continue on the path we are. As James said, we see this as an enormous market opportunity, and we will continue to go patiently after this marketplace.

Suzi Stein - *Morgan Stanley - Analyst*

Okay, great. Thank you.

Operator

And with no further questions, I would now like to turn the conference back over to management for closing remarks.

Nate Davis - *K12 Inc. - Chairman and CEO*

Well, I don't really have any long management remarks from the rest of the team. I know that to the extent that you have follow-up questions, Mike Kraft, myself, James Rhyu and Tim Murray are all available to chat. I want to thank everybody for their time this morning. And operator, I think that concludes our call.

Operator

Thank you for joining today's conference. That concludes the presentation. You may now disconnect, and have a great day.

Editor

Mr. Davis' response to the question presented by Suzanne Stein, Morgan Stanley, about uncapped enrollment in certain Florida counties was not correct. Enrollment caps established in those two jurisdictions combined are approximately 750 students for next school year 2014-15.