

ITT Educational Services Inc

3Q10 Results Highlight ESI Challenges Ahead

This morning, ESI reported its 3Q10 EPS of \$2.82 (vs. consensus \$2.73; JPMe \$2.67). However, ~\$0.12 of the beat came from share repurchases. The company reconfirmed its full-year 2010 EPS guidance (at \$11.00-\$11.35). Operating efficiencies in both expense lines drove an impressive operating margin expansion of ~200 bps y/y.

- **We don't think it is "business as usual."** While mgmt presented a "business as usual" picture, we think ESI is actively working on various impact scenarios and implementing strategies (increasing the number of recruiters, changing media mix) to address risks of possible regulatory/legislative changes. Broadly speaking, we think that DC concerns (gainful employment, Senate hearings, GAO findings) are starting to impact fundamentals of education services companies. While there is still uncertainty around what the final version gainful employment regulations will look like and what elections may bring to the table, we get a sense that education companies are adjusting marketing messages, tweaking processes, and perhaps re-focusing on identifying students more likely to succeed.
- **Growth strain is visible, but few countercyclical risks yet.** Revenues grew healthy 18% y/y, but showed signs of fatigue as new and total enrollments missed our and consensus estimates (for the second consecutive quarter), and retention and revenue per student declined. ESI's new enrollments declined 4% y/y (for the first time since 2001) and have underperformed normal seasonal trends for the third consecutive quarter. Mgmt stated that the y/y decline was due to 1) difficult comparables (all-time high starts in 3Q09), 2) lower productivity of newly hired enrollment counselors, and 3) change in media mix. On the point of **countercyclicity**, while mgmt stated that ESI had not seen a decline in demand for its programs, we think the company will see stronger countercyclical headwinds when the unemployment rate declines (most likely in late 2011 or 2012).
- **We remain Neutral on ESI.** We raise our 2010 EPS by \$0.08 to \$11.21, but lower 2011 EPS by \$0.30 to \$11.90. Trading at 5x our 2011 est. vs. the sector average of 8x, shares of ESI properly reflect the regulatory and countercyclical overhang in our view. We are also establishing a Dec 2011 PT of \$75. **While ESI is an inexpensive stock, we prefer APOL as a value play.**
- **Please register:** November 9, 2010, New York City: J.P. Morgan Ultimate Services Conference will feature a dedicated Education Services track.

ITT Educational Services Inc (ESI;ESI US)

	2009A	2010E (Old)	2010E (New)	2011E (Old)	2011E (New)	2012E
EPS - Recurring (\$)						
Q1 (Mar)	1.56	2.46A	2.46A		2.79	
Q2 (Jun)	1.85	2.78A	2.78A		3.02	
Q3 (Sep)	1.98	2.67	2.82A		2.88	
Q4 (Dec)	2.56	3.22	3.17		3.21	
FY	7.91	11.13	11.21	12.20	11.90	11.27
Bloomberg EPS FY (\$)	7.80		11.18		12.14	11.66
P/E FY	7.4	5.3	5.2	4.8	4.9	5.2

Quarterly EPS in 2009 do not add up to annual 2009 EPS due to share repurchases.

Source: Company data, Bloomberg, J.P. Morgan estimates. 'Bloomberg' above denotes Bloomberg consensus estimates.

See page 6 for analyst certification and important disclosures.

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Neutral

ESI, ESI US

Price: \$58.45

▼ Price Target: \$75.00

Previous: \$120.00

Education Services

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J.P. Morgan Securities LLC

Price Performance



If you are interested in obtaining a copy of our ESI model, please contact your salesperson.

SAVE THE DATE

Ultimate Services Conference

Tuesday, November 9, 2010

J.P. Morgan Conference Center

New York City

Company Data

Price (\$)	58.45
Date Of Price	21 Oct 10
52-week Range (\$)	121.98 - 50.00
Mkt Cap (\$ mn)	1,929.49
Fiscal Year End	Dec
Shares O/S (mn)	33
Price Target (\$)	75.00
Price Target End Date	31 Dec 11

Growth strain is more visible in 3Q10. Revenues grew a healthy 18% y/y, but showed signs of fatigue as new and total enrollments missed our and consensus estimates (for the second consecutive quarter), and retention and revenue per student declined.

ESI's new enrollments declined 4% y/y for the first time since 2001. Management stated that the y/y decline in starts was due to 1) incredibly difficult comparables (all-time high starts in 3Q09), 2) lower productivity of newly hired enrollment counselors (whose number grew 20% y/y), and 3) change in media mix. On a sequential basis, we note that starts have underperformed normal seasonal trends for the last three quarters (23% in 3Q10 vs. 43% average, -6% in 2Q10 vs. +5% average, and 18% in 1Q10 vs. 24% average).

Countercyclical headwinds should be forthcoming. Management stated that ESI had not seen a decline in demand for its programs, consistent with what we hear from other operators in the space. We think the company will see stronger countercyclical headwinds when the unemployment rate declines (most likely in late 2011 or 2012). We note that due to its focus on associate's degrees, ESI saw more tailwinds (over the last two years) than the sector overall.

Student persistence headwinds appear to be stronger. Student persistence declined 120 bps y/y in 3Q10, following an 80 bps y/y decline in 2Q10. Management pointed to 1) declining student retention, particularly for the second-year students and 2) higher number of graduates in 3Q10 (and for the next several quarters), both of which impact our simplified persistence metric. Management suggested that tweaking scholarship policies (such as placing greater emphasis on completion-based awards) should improve second-year persistence, which we think is wise. While ESI does not disclose the number of graduating students, we find it reasonable that higher graduation for ESI programs (predominantly associate's degree) happens approximately two years after new enrollments began to surge (in 2Q08).

Investment Opinion

- **Long history of consistent growth is attractive in this environment.** With top-line and EPS CAGRs of 13% and 27%, respectively, over the last 14 years, ITT is one of the most consistent operators in the space. Its mostly organic expansion strategy resulted in 35%+ returns on capital and most recently 80%+ (far outpacing its peers).
- **Vertical expansion to higher degree levels is positive to brand and margins.** Upstream shift is highly attractive for ITT, as it may be able to prolong duration of students' stay, and improve retention rates, both of which have positive implications for margins. Management cited that 30% of its associate's degree candidates matriculate to the bachelor's degree level.
- On balance, **downside risks** include potential negative effects of ITT's high tuition (\$41,000 for associate's degree, the most costly in the sector). Over the intermediate term, pricing power may be limited compared to its peers, evidenced by the expanded use of scholarships. High tuition rates have also led, in part, to industry-high operating margins; that said, given the massive operating margin expansion, it is hard to verify whether ESI is investing enough in its infrastructure and growth initiatives. In addition, high tuition rates and resulting profitability

also attract the attention of regulators, particularly in relation to the ED's proposed "gainful employment" regulation.

- **In addition, high exposure to private lending could result in upside or downside volatility**, depending on the resolution of the lending challenges. We estimate that ESI will receive ~12-16% of revenues in 2010 from private loans (institutional and third-party), making the company one of the institutions in our coverage most affected by the student lending challenges.

Outlook

ESI confirmed its full-year 2010 EPS guidance at \$11.00-\$11.35. In addition, management confirmed bad debt to remain unchanged at 4-6% range (down from 6.2% in 2009), and for DSO to remain at 10-15 days (from 21 days in 2009). The decline in these metrics is primarily driven by the ramp-up of the PEAKS program, which will substitute for much of the on-balance sheet financing. In addition, management confirmed its 2010 FCF target at \$500mln (up from \$271mln in 2009).

We expect 4Q10 revenue to grow 9% y/y, driven by 11% y/y growth in total enrollment (reported in 3Q10) and offset by a 2% y/y decline in revenue per student. We also expect ~85 bps y/y of operating margin expansion in 4Q10 and EPS of \$3.17. 4Q10 bad debt (as percentage of revenue) should decline ~100 bps y/y to 5.9%, but advertising costs should be up y/y (due to rising spot advertising rates for traditional media).

For 2011, we estimate revenue growth of 2% y/y driven by 3% y/y growth in average enrollment but offset by a modest decline in revenue per student. We think that efficiencies in the expense lines are likely to produce ~50 bps y/y of operating margin expansion (to 39.4%). Our full-year 2011 EPS estimate is \$11.90, down from our previous estimate of \$12.20. We also think that 2011 FCF will be lower than in 2010 as benefits from the PEAKS program (which refinances on-balance sheet loans) will diminish.

We are also introducing our 2012 EPS estimate of \$11.27, which reflects our expectation of countercyclical headwinds starting in 2012 and potential operating changes in preparation for gainful employment regulations. However, our estimates do not include the impact of the gainful employment sanctions (starting in July 2012), as the Education Department plans to propose the final version of the regulations in early 2011.

Valuation

Trading at 5x our 2011 estimate vs. the sector average of 8x, shares of ESI are fairly valued in our view, partly due to the risks and uncertainties around ESI's exposure to the Education Department's proposed regulations and countercyclical overhang. Please refer to Table 1 for sector valuation metrics.

We are also establishing a Dec-2011 PT of \$75 for ESI. We obtain this price target by applying 6.5x multiple to our 2012 EPS estimate of \$11.27. We think this multiple (6.5x, a slight premium to the current forward P/E multiple of 5x) appropriately reflects a more normalized environment for education services in 2011.

Our prior Dec-2010 PT of \$120 was based on a 10x multiple and our prior 2011 EPS estimate of \$12.20. The 10x multiple reflected an average forward multiple for the last year through June.

We maintain our Neutral rating on ESI.

Table 1: Comparative Valuation Table

Company	Ticker	JPM Rating	JPM Price Target US\$ 12/31/2010	Price US\$ 10/21/2010	% of 52-Wk High	Stock Performance, %			Market Cap (US\$ MM)	Enterprise Value (US\$ MM)	EPS CY2010	EPS CY2011	EPS Growth	P/E NTM	P/E CY2010	P/E CY2011	P/Sales LTM	EV/EBITDA CY2010	FCF Yield LTM
						YTD 2010	1 Year	2 Year											
American Public Education	APEI	NR		\$32.80	67%	-5%	-6%	NA	\$624	\$538	\$1.50	\$1.84	23%	20.3x	21.9x	17.8x	3.6x	9.8x	5.1%
Apollo Group	APOL	OW	\$65	\$36.27	47%	-40%	-51%	-39%	\$5,380	\$3,762	\$4.01	\$4.36	9%	8.2x	9.0x	8.3x	1.1x	2.6x	14.0%
Bridgepoint Education	BPI	N	\$23	\$14.13	51%	-6%	-7%	NA	\$858	\$652	\$1.86	\$2.31	24%	7.6x	7.6x	6.1x	1.5x	3.1x	15.6%
Capella Education	CPLA	N	\$90	\$66.95	68%	-11%	-1%	56%	\$1,139	\$947	\$3.70	\$4.59	24%	16.3x	18.1x	14.6x	3.0x	8.2x	4.9%
Career Education	CECO	NR		\$17.33	48%	-26%	-29%	6%	\$1,419	\$1,109	\$2.99	\$3.34	12%	5.5x	5.8x	5.2x	0.7x	2.5x	12.5%
Corinthian Colleges	COCO	NR		\$4.62	24%	-66%	-75%	-69%	\$409	\$514	\$1.52	\$1.16	-24%	3.5x	3.0x	4.0x	0.2x	1.8x	46.4%
DeVry	DV	OW	\$75	\$44.64	60%	-21%	-19%	-10%	\$3,227	\$2,907	\$4.32	NA	NA	9.7x	10.3x	NA	1.8x	5.5x	9.8%
Education Management	EDMC	N	\$18	\$10.15	38%	-54%	NA	NA	\$1,462	\$2,627	\$1.69	\$2.03	20%	5.3x	6.0x	5.0x	0.6x	4.1x	15.0%
Grand Canyon Education	LOPE	NR		\$20.24	71%	6%	NA	NA	\$942	\$897	\$1.25	\$1.68	34%	13.6x	16.2x	12.1x	2.9x	8.0x	0.5%
ITT Educational Services	ESI	N	\$75	\$58.45	48%	-39%	-47%	-28%	\$1,929	\$1,817	\$11.21	\$11.90	6%	4.9x	5.2x	4.9x	1.2x	2.8x	17.9%
Lincoln Education	LINC	NR		\$12.25	43%	-43%	-46%	-7%	\$324	\$333	\$2.47	\$2.54	3%	4.8x	5.0x	4.8x	0.5x	2.4x	15.3%
Strayer Education	STRA	OW	\$270	\$127.99	49%	-40%	-41%	-36%	\$1,754	\$1,626	\$9.83	\$11.70	19%	12.4x	13.0x	10.9x	3.0x	6.8x	6.9%
Universal Technical Institute	UTI	NR		\$18.15	72%	-10%	-8%	6%	\$449	\$357	\$1.35	NA	NA	12.2x	13.4x	NA	1.1x	NA	5.6%
J.P. Morgan Market Cap Weighted Mean						-30%	-30%	-16%						9.1x	9.9x	8.4x	1.6x	4.4x	12.2%
Mean					53%	-27%	-30%	-13%						9.6x	10.3x	8.5x	1.6x	4.8x	13.0%

Note:
 1. EPS Estimates: Companies under coverage (APOL, BPI, CPLA, DV, EDMC, ESI, STRA)- JP Morgan estimates, others are Bloomberg consensus estimates
 2. JPM Ratings: OW - Overweight, N - Neutral, U - Underweight, NR - Not Rated, NTM - Next 12 months, LTM - Last 12 months
 Source: J.P. Morgan estimates, Bloomberg, Company reports

Third Quarter 2010 Analysis

3Q10 Revenues grew 18% y/y to \$401 million, below our 19% y/y growth estimate. Revenue per student declined 2.5% y/y, below our -1% y/y estimate. Total enrollments in 3Q10 grew 11% y/y (to 88,004), while 3Q10 starts fell 4% y/y (to 26,664). 3Q10 Student persistence declined 120 bps y/y.

Efficiencies in the Costs of Educational Services were mild, resulting in a ~80 bps y/y gain in gross margin (to 66.4%), in line with our estimate. Student Services and Administrative Expenses declined 123 bps y/y to 28.6% of revenue (vs. our estimate of 29.1%). The improvement was attributed to a ~130 bps y/y decrease in bad debt expense (to 5.5% of revenues), offset by increased media costs (up 25% y/y) and larger enrollment staff (up 20% y/y). Management expects continuation of bad debt expense improvements in 4Q10.

3Q10 Operating margin increased a solid ~200 bps y/y to 37.8% of revenues, compared to our estimate of 37.3%, the third-highest level in recent history (4Q09 showed the highest margin).

3Q10 Income tax rate was 38.5%. 3Q10 EPS grew 43% y/y to \$2.82, above our prior estimate of \$2.67. However, approximately \$0.12 of the beat came from share repurchases.

On the balance sheet, net cash was \$113 million, or \$3.41 per share. Deferred revenue increased 33% y/y to \$195 million and now represents 49% of revenue.

In addition, days sales outstanding were 20 days (down 6 days compared to 3Q09). The decrease in DSOs resulted primarily from an increase in the amount of funds students received from third-party private education loans and scholarships in 2010.

Cash flow from operations grew 56% y/y in 3Q10 to \$117 million and **free cash flow** grew 53% to \$109 million. 3Q10 **Capex** was 2.0% of revenue, or \$8 million.

ITT repurchased ~1.8 million shares of its stock for ~\$115 million, shrinking the diluted share count by 4% sequentially and 13% y/y. In October, the company's Board increased its share repurchase authorization by 5 million shares. As a result, the company has ~6.7 million shares remaining under authorization.

ITT opened one new campus in Phoenix bringing the number of campuses to 126. The company also has four learning sites. Management noted that they anticipate beginning operations of three to five additional locations during 4Q10, putting ESI on track to achieve a goal of opening eight to ten locations in 2010.

ESI management did not make incremental comments about pending regulations on gainful employment.

Company Description

Headquartered in Indianapolis, IN, ITT Educational Services, through its sole school brand ITT Technical Institutes, operates a network of degree-granting accredited schools and offers certificate, associate's, bachelor's, and master's degrees. ITT typically serves students looking to gain entry-level jobs in a new profession and currently enrolls more than 85,000 students. The company grants degrees in technology, business, criminal justice, and allied health and operates 126 ITT institutes and four learning centers in 37 states. ITT institutes are nationally accredited by the Accredited Council of Independent Colleges and Schools (ACICS).

Other Companies Recommended in This Report (all prices in this report as of market close on 20 October 2010)

Apollo Group (APOL/\$36.86/Overweight)

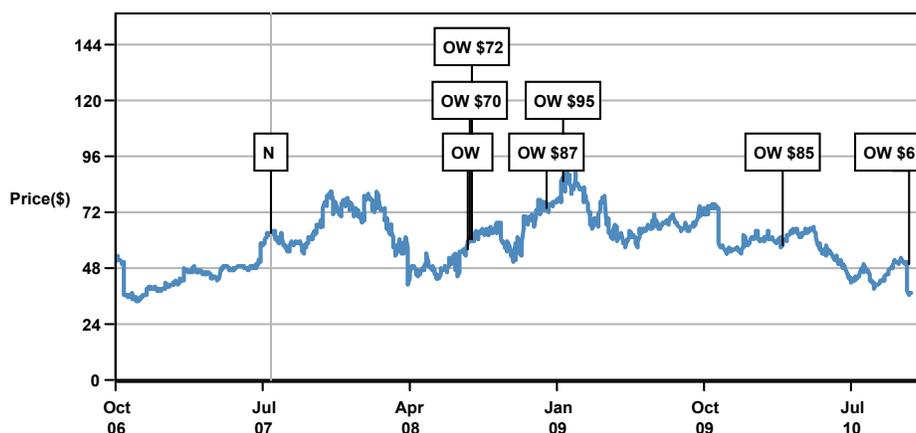
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Apollo Group (APOL) Price Chart



Date	Rating	Share Price (\$)	Price Target (\$)
16-Jul-07	N	62.78	--
17-Jul-08	OW	55.52	--
22-Jul-08	OW	60.34	70.00
23-Jul-08	OW	60.34	72.00
11-Dec-08	OW	73.53	87.00
09-Jan-09	OW	85.27	95.00
22-Feb-10	OW	57.90	85.00
14-Oct-10	OW	49.50	65.00

Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends.
 Break in coverage May 03, 2005 - Jul 16, 2007. This chart shows J.P. Morgan's continuing coverage of this stock; the current analyst may or may not have covered it over the entire period.
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ITT Educational Services Inc (ESI) Price Chart



Date	Rating	Share Price (\$)	Price Target (\$)
16-Jul-07	N	119.96	--
23-Jan-09	N	126.21	135.00
24-Apr-09	N	100.82	115.00
23-Apr-10	N	112.69	120.00

Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends.
 Break in coverage May 03, 2005 - Jul 16, 2007. This chart shows J.P. Morgan's continuing coverage of this stock; the current analyst may or may not have covered it over the entire period.
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