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Pummeled Education Stocks May Now Look Appealing: John Dorfman

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Shares in companies that run for- profit colleges have been smashed this year.

The industry will survive, but not all its members. An index of 13 education companies has declined 32 percent this year. These institutions may face reduced enrollments because the federal government is tightening rules for student loans. Yet some of the stocks have been punished too severely, I believe.

Apollo Group Inc., the largest education company in terms of enrollment, appears attractive to me at the current price of about $35 a share. The stock began this year at about $61, down from more than $97 in 2004.

Phoenix-based Apollo includes the University of Phoenix system, which has more than 538,000 alumni, according to the company's website. Its students attend classes online or in sites around the country.

Apollo and its rivals face new federal regulations and harsh criticism.

Critics say the for-profits recruit students willy-nilly to snag tuition dollars, regardless of whether applicants have the skills to handle the coursework.

Most student loans are issued by private companies but guaranteed by the federal government. That means the U.S. Treasury is left holding the bill if schools don't prepare their graduates to find a job and repay their loans.

Loan Payback

The loan repayment rate is only 36 percent for for-profit colleges compared with 54 percent at public universities and 56 percent at private nonprofit schools, according to an analysis of U.S. Education Department data by the Institute for College Access and Success, a nonprofit research

group.

The repayment rate is basically the percentage of former students who are up to date in making interest payments on their loans and are also paying down at least part of the principal.

The default rate -- the number of people who gave up on paying their loans, forcing the federal government to reimburse the lenders -- was 7 percent in fiscal year 2008. The rate was about 4 percent for students of private nonprofits, 6 percent for alumni of public institutions and 11 percent for people who attended for-profit colleges, according to the Education Department.

The for-profits say their higher default rates result because they serve a higher percentage of students from poor backgrounds, belong to minority groups or have parents who never attended college.

The for-profits have a point there, but whether they were greedy doesn't matter anymore. We are now entering an era of tighter government spending, and there likely will be less tolerance for tardy repayments or defaults on student loans.

Revising the Rules

New rules may come from the Education Department, Congress or both.

Last summer the department proposed denying federally guaranteed loans to students who plan to attend a for-profit program with a repayment rate of less than 35 percent. The rules would also impose enrollment growth restrictions on for-profit schools with repayment rates of 45 percent or less.

Colleges could also maintain their loan eligibility by demonstrating that graduates met certain debt-to-earnings ratios.

Congressional Hearings

Congress will hold hearings early next year, and I believe a bill will pass that resembles the Education Department's proposal.

My judgment -- based on cobbling together figures from news reports, government statistics and brokerage-house reports -- is that Apollo already exceeds the 35 percent repayment rate standard and can get to the 45 percent level pretty easily.

By contrast, some competitors may have a hard time living up to the new standards. For example, I

would avoid Corinthian Colleges Inc.'s stock.

Corinthian, based in Santa Ana, California, says it operates 100 schools in the U.S. and 17 in Canada. In my opinion, it will have a difficult time consistently exceeding the 35 percent threshold. Investors may be thinking the same thing: Corinthian shares are down 66 percent this year.

Corinthian also has another problem. On Nov. 2 it said students may have to pay higher tuition prices because "a substantial percentage" of its colleges may be in violation of an existing federal rule that limits federal student aid to no more than 90 percent of a college's revenue.

More Problems

Complicating matters, the new rules would probably apply to specific programs at an institution, not necessarily to the institution as a whole. Career Education Corp., based in Hoffman Estates, Illinois, said in August that its culinary and art-and- design courses "would be more impacted" than its health and university segments.

Career Education as of Sept. 30 had $284 million in cash and equivalents and $159 million in short-term investments. This hoard may help it pay for, and withstand, the transitions ahead.

Apollo Group has almost $1.3 billion in cash and equivalents.

Another for-profit I like is DeVry Inc., with headquarters in Downers Grove, Illinois. It has a strong reputation in health-care and professional-development courses. The company says that 90 percent of its graduates find jobs in their chosen fields.

DeVry has been public since 1991, has no debt, and has about $451 million in cash and equivalents. At 11 times earnings, the stock is more expensive than some peers, but within my comfort zone.

Disclosure note: I have no long or short positions for myself or for clients in any of the stocks discussed in this article.

(John Dorfman, chairman of Thunderstorm Capital in Boston, is a columnist for Bloomberg News. The opinions expressed are his own. His firm or clients may own or trade securities discussed in this column.)

To contact the writer of this column: John Dorfman at jdorfman@thunderstormcapital.com.

To contact the editor responsible for this column: James Greiff at jgreiff@bloomberg.net