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Postsecondary Education

NACIQI: Unclear if Future of Accreditation Evolutionary vs. Revolutionary

3 December 2010

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■ We attended NACIQI this week; investment community was largely absent

Along with 100 industry stakeholders, we attended NACIQI Dec 1-2 in Washington DC. We were surprised by the absence of securities analysts in the audience, which indicates to us that investors potentially do not anticipate or perhaps understand the risk associated with changes to accreditation.

■ NACIQI to provide recommendation on HEA reauthorization next year

DOE Secretary Duncan has requested NACIQI to provide recommendations on the future of accreditation by this time next year. Next step: NACIQI will hold a policy forum in February (Exhibit 1). Based on conversations with members of NACIQI and accreditors in the audience, it is unclear to us whether such changes prove evolutionary or revolutionary. We posit that substantial changes to accreditation could meaningfully impact the operations of all postsecondary institutions, including those owned by companies that we cover.

■ HLC portion of hearing very tame – no negatives

HLC's accreditation remains intact, with NACIQI recommending that HLC's compliance report be accepted. NACIQI participants were quite congenial, far from the politicized confrontational affair that we were concerned it could be.

■ We continue to favour LOPE and APEI

Our favourite names from most to least favourite: LOPE; APEI; WPO; CPLA; APOL; STRA; DV; CECO, ESI, and COCO.

Lack of Interest by Institutional Investors Startling

Investor fixation solely on gainful employment remains understandable but largely short-sighted in our opinion. We think that investors need to get up to speed on potential changes to accreditation and the potential impact that such changes could have on company business models. We remind investors that many dismissed negotiated rulemaking on program integrity at the beginning of the process, and could not comprehend that the government could meaningfully take action to reform the for-profit sector. We advise investors not to make a similar error as it relates to accreditation. We expect the February NACIQI policy forum to be better attended by the investment community.

Changes to Accreditation Could Prove Significant

Eduardo Ochoa, Assistant Education Secretary for Postsecondary Education, started off the NACIQI hearing by raising serious questions about accreditation and the federal role in it. Continually he suggested that "the stakes are higher" given increased federal funding to the sector, and questioned whether the accrediting agencies are up to the task of ensuring quality. Questions he posed included whether the right measures of student success exists. We acknowledge that such comments are not new – concerns regarding the current system of accreditation echo those raised in the Spellings Commission from 2006, particularly on the accountability and transparency of postsecondary institutions. However, what is new is that the process is currently underway to potentially change accreditation under an administration that has demonstrated a willingness and aptitude to put in motion meaningful change in the face of substantial opposition. Members of NACIQI and accreditors in the audience that we spoke with had little insight into how significant such changes could be.

We concede that at this time we do not know exactly what changes could take form, and what impact such changes could have on publicly traded postsecondary institutions. NACIQI has been charged to develop recommendations to the DOE for informing the 2013 reauthorization of the Higher Education Act (HEA). Assuming that the Act does pass in 2013, rules in place could take effect years afterward. Change in how postsecondary institutions provide quality and value to students is not imminent. However, we posit that material change could impact all of postsecondary, which at a bare minimum introduces elements of uncertainty that could continue to scare away institutional investors from the sector.

Some would suggest that the sector becomes investable again after some clarity exists regarding gainful employment rules and the impact on companies. Our understanding of the short seller thesis is that many for-profit institutions (or even non-profits) do not provide their students value. A change in the system of ensuring academic quality to quantifiable metrics, particularly for degree granting institutions (not so much for career schools that provide placement data) could in our opinion entice the shorts to stay for some time. In other words, investors potentially have to deal with changes to accreditation in addition to: the threat of increasing competition, price erosion if 90/10 were to

go away, increased customer acquisition costs, investigations by state attorney generals, and compliance with proposed gainful employment rules.

Exhibit 1: NACIQI February Policy Forum Worksheet

FEBRUARY POLICY FORUM

"Required Reading" (for before the Feb Forum)

- History of recognition and accreditation, and the linkage of recognition to student aid eligibility
- Current issues in accreditation

What is working (and not working) in the current system of recognition, accreditation, and student aid eligibility?

There is a huge (~$150B) federal investment in education. How well does that investment serve us? How well does our current accreditation/recognition system protect the interests of the taxpayer who is underwriting that investment in education? If we were starting now, would we design *this* system? How might a system we would design *differ* from what currently exists?

Our current system draws on a variety of actors, definitions, and processes, which, in turn, poses a number of tensions, points of confusion, and areas of overlap.

- There are commonalities and divergences among notions of "*quality assurance*," "*continuous improvement*," and "*compliance*."
- There is tension between notions of gate-keeping for the availability of student aid, and notions of accreditation as a broader quality assurance and quality improvement process.
- There is confusion and incomplete overlap about compliance with regulation versus accreditation via peer review.
- There are a number of actors: federal, state, professional/trade/membership organizations, and the public—all of whom play varying roles and have varying interests.

Some of the questions that arise from the conjunction of the above, include:

- What should be the role of the federal government? Of the states? Of the trade/professional associations? Of students and families?
- What are the costs/benefits of a system in which accreditors serve as the gatekeepers to federal funds?
- What tensions arise from accreditors specifying a set of standards, and the Department requiring data that address a different set of criteria?
- To what extend does a peer review process serve the compliance/gatekeeping function (or vice versa)?
- Is it possible/desirable to distinguish between "quality assurance" determinations and "continuous improvement" recommendations? Between the minimum acceptable for gatekeeping functions, and the broader quality and/or quality-improvement determination functions.

These "crosscutting questions" also give rise to questions about the actors, definitions, and processes themselves:

RECOGNITION

- Of the current criteria for recognition, which have value/should continue, and which don't/should not continue?
- Might there be a "tiered" and/or "developmental" approach to recognition (perhaps both an "honors" designation (and interest in disseminating the best practices of these), and a non-accrediting status that designates agencies as not re-recognized but as in process for regaining accreditation authority)?

COMPLIANCE

- Should there be common standards for learning outcomes/*student achievement (should the rule of construction stand, or should there be a set "standard" for student achievement?)* Who should decide those? How should they be measured?

QUALITY ASSURANCE

- What should be the metrics of quality?
- What benefits (other than access to student aid) accrue in a quality assurance process? Are those benefits worth the costs?

AID ELIGIBILITY

- Can/should the link between student aid and accreditation be severed?
- Should there be separate metrics and/or forms of recognition for compliance with regulation for the purposes of quality determination versus aid eligibility (e.g., an "ROI" model for aid eligibility)?

ACTORS

- What should be the role of accreditation associations? Of the national, regional, specialized accreditors?
- What kind of transparency/public reporting is needed?
- What is the relationship between accreditation and state authorities?
- What implications do costs have for the relationship between the institution and the accreditor? For the accreditor and the recognition process?
- What is the value of accreditation/accreditation to its constituencies (consumers/clients/patrons)?
- To what extent does the current system work to the benefit of the consumer's (student's) decision making? Is it a useful source of information?

Last, there are questions about the process of considering possible changes:

- Are there other models (from other areas of regulated activity, other countries, other industries) that address these issues better?
- What would we gain/what would we lose by pursuing some of the proposed solutions?
- Would recommendations best be geared to changes that are systemic, comprehensive, and/or polishing?

OTHER TOPICS of interest (may also be raised in the context of the "what's working/not" list above)

POSSIBLE NEW/ALTERED ISSUES FOR HEA LAW or REG?

- *Transfer of accreditation/sale of an accredited institution*
- *Credit hours (how does one measure credit hours?)*
- *Length of recognition (Should the recognition period be shortened? (note that staff have concern about this one))*
- *Fiscal Integrity (what standards of fiscal integrity might apply?)*
- *Student mobility (how can institutions assist the movement of students across institutions?)*
- *Institutional productivity (should there be set acceptable completion/placement rates? Might the law/regs incentivize institutions to be more productive of college graduates/employed graduates? (note Carnegie Mellon and UMD initiatives))*
- *Geographic limitations on accreditors and expanding/constraining institutional choice or accreditor?*

ISSUES CONCERNING THE IMPLENTATION OF REGULATIONS

- *Concerns about need for verifiable data review for compliance with Secretary regs, relative to:*
  - *i. concerns that imposing data requests that may be intrusive in terms of academic judgment and burdensome on accreditors*
  - *ii. concerns about a level of conformity and prescriptiveness that may not provide adequate flexibility for the diversity of institutions in US higher education*
  - *iii. concerns about the critical and sufficient data elements that are needed to evaluate the quality assurance process.*
- *Concerns about the stability of interpretation of review criteria, and about the opportunity for notice and comment on changes in interpretation*

Source: U.S. Department of Education

Statement of Risk

The main downside risks to postsecondary education stocks include: a deceleration in the growth rate or an actual decline in enrollments, driven by an improving economy and compliance with current and potentially new rules from regulatory bodies. An improving economy and increased competition could also increase sales and marketing costs which could in turn pressure margins. Given that federal student loans represent a majority of the company's revenue, legislation, whether enacted or proposed, could significantly alter company business models.

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Neutral	**Hold/Neutral**	40%	33%
Sell	**Sell**	9%	22%
UBS Short-Term Rating	**Rating Category**	**Coverage[3]**	**IB Services[4]**
Buy	**Buy**	less than 1%	20%
Sell	**Sell**	less than 1%	0%

1:Percentage of companies under coverage globally within the 12-month rating category.
2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.
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Source: UBS. Rating allocations are as of 30 September 2010.

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Company Disclosures

Company Name	Reuters	12-mo rating	Short-term rating	Price	Price date
American Public Education Inc[16]	APEI.O	Buy	N/A	US$34.36	02 Dec 2010
Apollo Group Inc.[16]	APOL.O	Neutral	N/A	US$35.35	02 Dec 2010
Capella Education Co[16]	CPLA.O	Neutral	N/A	US$56.46	02 Dec 2010
Career Education Corp.[16]	CECO.O	Neutral	N/A	US$18.31	02 Dec 2010
Corinthian Colleges Inc.[13, 16]	COCO.O	Sell	N/A	US$4.24	02 Dec 2010
Grand Canyon Education Inc[16]	LOPE.O	Buy	N/A	US$19.00	02 Dec 2010
Strayer Education Inc.[16]	STRA.O	Neutral	N/A	US$135.50	02 Dec 2010
Washington Post[16]	WPO.N	Neutral	N/A	US$387.61	02 Dec 2010

Source: UBS. All prices as of local market close.
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