Signal Hill

Business Services - Education Services

Initiating Coverage

August 13, 2010

Regulatory Update: Lies, damn lies, and statistics*

Trace Urdan
turdan@signalhill.com
415.364.0365

Our Call:

In its call with investors yesterday, the government provided some limited clarification regarding its proposed Gainful Employment rules, and no doubt whatsoever that it believes the rules to be perfectly conceived and designed. It also confirmed its intention to release this Friday – to the public – institution- specific repayment rates. Though these rates will still not be available on a per-program basis, the government believes there will not be a substantial difference between institutional rates and institutional program-specific rates and believes that analysts (aka investors) should be able to reach conclusions from examining this data.

Though there was no material information presented in our opinion, there was additional clarification regarding the Department's methods and thought process. In particular the extent of the government's reliance on the Missouri study was made clear. All of the program-specific data comes from the State of Missouri study despite the fact that Missouri might under-represent minority and economically-challenged student populations. This in turn suggests that the standards conceived around Missouri could be aggressive.

As a remedy for schools that find themselves potentially challenged, Department of Education policy-executor David Bergeron encouraged improved classroom rigor, remedial classes for recent graduates, and collection efforts re-focused to encourage payment on principal rather than not merely deferment. Irrelevant as we regard the former suggestions, the latter could be the one that makes all the difference for the companies' compliance with the new rules in the long run.

This firmly-held belief that program quality directly reflects on repayment in turn informs the government's conviction, as reflected in Mr. Bergeron's comments, that enrollment levels should be unaffected in the sector by the new rules. We expect that most operators in the space, many of whom have deliberately begun efforts to restrict or otherwise encourage early attrition through entrance tests and or early orientation programs, would disagree with this assessment.

Barring extraordinary anomalies in terms of disproportionate deferments, we expect the repayment data released on Friday (we don't know precise timing though some have suggested late in the day) through the IPEDS data site, will roughly line up high-low according to the three-year CDR performance. Mark Kantrowitz, director of Finaid.org, more expert than we are in analyzing student debt, has suggested that a 24% or under 3-year CDR should clear the 45% repayment threshold and a 30% or higher CDR will likely fall below he 35% repayment threshold.

In this context Corinthian's Everest College (NASDAQ: COCO; Buy) with three-year CDRs average above 30% should be clearly challenged by the 35% threshold. Those that could fall in the warning track include Lincoln Tech (NASDAQ: LINC: Buy) and allied health schools Brown Mackie (NASDAQ: EDMC; Buy), Western Career College (NYSE: DV; Buy), Sanford Brown (NASDAQ: CECO; Buy) though this latter category could potentially be made safe through price reductions. Per Mr. Kantrowitz's analysis, ITT Tech (NYSE: ESI; Buy) could be right on the bubble.

* with apologies to Mark Twain.

Investment Analysis:

In its Notice of Proposed Rulemaking (NPRM) for Gainful Employment, and in its presentation to analysts yesterday, we get as complete a picture as we've had to date of the administration's attitudes and intentions with respect to for-profit education. In this justification for the rulemaking process we see reflected elitism regarding which kinds of education "have value," an unproven assumption that institutions control employment and income directly by the quality of their offerings, and a fundamental mistrust of a market-based system for allocating resources:

The standards for institutions participating in the HEA title IV student financial aid programs are important to protect taxpayers against wasting resources on educational programs of little or no value that also lead to high indebtedness for students. The proposed standards also protect students who lack the information needed to evaluate their postsecondary education options and may be mislead by skillful marketing, resulting in significant student loan debts without meaningful career opportunities. Unlike publicly controlled or non-profit institutions – for-profit institutions are legally obligated to make their profitability for shareholders their overriding objective. Furthermore, for-profit institutions and may be subject to less oversight by States and other entities.

This is not a statement suggesting that students need to be afforded better information or protection, or that marketing practices need to be reigned in through tighter controls or better enforcement or altered incentives. Rather this is a view that a market-based system cannot be trusted when it comes to allocating post-secondary services.

In our opinion, the presentation reflects mistrust in one of the core tenets of federal higher education policy which invests universally accessible benefits, irrespective of means, with students rather than institutions. The NPRM statement suggests that the Department believes that this market-oriented mechanism is inadequate to the task of ensuring a quality product in higher education. It does not attack unscrupulous sales tactics like those observed in the GAO investigation. Rather it faults "skillful marketing" and students too poorly-equipped to make informed decisions about which programs to pursue and how much to borrow. It uses sociological studies as well as other, less substantiated assumptions about to-be-preferred life choices (saving for retirement, buying a home, or saving for their own children's education) to engineer outcomes, thereby presuming to protect students from their poor choices. Its premise is that if schools do not protect students from themselves, then government has no choice but to take on the role.

In its preamble and in its recent conference call with analysts, (and in the rules themselves,) the government assumes that schools, through course design and quality of instruction, determine employment and loan repayment outcomes. Without study or support, the government makes a set of extraordinary assumptions that lays responsibility for defaults squarely on the schools rather than the students. In describing borrower distress resulting in a default, the Department writes: *"That distress may be the result of a borrower not being employed, having inadequate income, feeling they were rushed into a loan without adequate information, or dissatisfaction with the quality or type of education that was provided."* Yet there is no study or regression analysis proving this correlation or even determining to what extent each factor is relevant. In fact, judging from statements made on yesterday's call, the confidence for this statement seems to come solely from anecdotal observations included in the Missouri study.

"The high default rate in for-profit programs appears to indicate substantial barriers to providing value to enrollees, beyond what could be explained by informed investment on the part of students."

At one point in the NPRM (and again in yesterday's call,) the government proposes that restricted schools pursue steps to improve their offerings in order to correct repayment and/or debt/income metrics. Yet again the government offers no studies or basis to support the assumption that these outcomes are related to inadequacies in the program offerings. In fact, it seems very clear from the available data, much of which was left out of the government's analysis, that what really matters is who the schools enroll, not what instruction they offer.

The government by contrast attempts to minimize the role of socio-economic factors by noting that the CCA's own study cannot account for the entire differential in defaults on the basis of income. However, what has long frustrated us about this analysis is that it does not control for the difference in program type and the difference in socio-economic status at the same time. Because the for-profit schools skew toward vocational programs in total population, the analysis fails to compare apples to apples. In our view the proper analysis would compare

non-degree with non-degree across type of institution, associate with associate, etc. For this reason, we reject the conclusion that there is any proven quantitative difference between the caliber of instruction or outcomes based on the institutions' governance structure.

On the contrary, in our experience at the vocational level, which is the area that seems most challenged under the new rules, for-profit programs, versus those offered by community colleges, tend to offer the most hands-on attention, the smaller class sizes, the more flexible schedules, the most modern equipment, and the most earnest and aggressive job placement. Perhaps as a consequence of these generally superior efforts, proprietary schools tend to have fewer drop-outs than community colleges. The principal difference between them, of course, is that community colleges are subsidized by state and municipal taxpayers.

The government cites a Florida study:
http://www.oppaga.state.fl.us/MonitorDocs/Reports/pdf/1018rpt.pdf
which it insists shows that for-profit institutions were *"more expensive for taxpayers on a per-student basis due to their high prices and large subsidies."* Yet this is not at all what the study demonstrates. On the contrary, the analysis suggests that half of the programs studied cost more per-student when state subsidies were factored in. Defaults represented no part of the analysis, not did state or federal taxes paid by the for-profit schools. The study did conclude that private institutions graduated a number of students and that those students, despite lower first-time scores on licensure exams, earned the same amount as students from community colleges. The lower cost of the community college programs suggested that students might have better returns attending state-subsidized programs, but the study did not reach the conclusion that on a per graduate basis, that taxpayers were better off with the public system. It did not even address this point.

Publicly-funded institutions easily satisfy the government's new debt-to-income standards as their taxpayer-subsidized tuitions require little, if any, borrowing. But the suggestion that this relates to a different quality of instruction or that they somehow better prepare students for gainful employment is not only unsupported by fact, but strikes us as plainly ludicrous. What that simple case reveals is the ulterior motive of the Department and the very thin basis for the rules in the statute.

That motive of course is an inflated sense of crisis around student borrowing. The department cites declining inflation-adjusted wages for BA degree graduates but rising levels of student debt. This statistic is presented as evidence enough of a problem. But what is not presented alongside this data is the dramatic increase in college attendance among working adults. These students are independent of their parents and rely more heavily on student loans to attend college. The increased borrowing may be partly a function of rising tuition prices and tighter employment markets, but is certainly a function of the increase in the number of students with limited means. To suggest that this is a crisis is to suggest that at a policy level we begin to evaluate participation in Title IV on the basis of return to the taxpayer rather than on the basis of providing equal opportunity to all students. In fact, the implication of the new policy – and indeed a likely consequence of its application – will be to perversely supply Title IV benefits more readily to middle and upper middle class students.

On its call yesterday, the government revealed the naivety of its assumptions, suggesting that they believed there would be no reduction in enrollment as a result of the proposed rules. But investors know well that this reduction is already taking place. The operators of the school (and indeed investors intuitively) know what the government is loath to admit – the best way to improve repayment and debt/income rates is to restrict enrollment to students with better academic track records and, perhaps more importantly, better credit scores. The schools understand this as well as they understand that the only way to avoid the inevitable clash between debt/income restrictions and the 90/10 rule is to eliminate low-cost skill-retraining programs that serve unskilled workers.

The elephant in the room then, is the role of socio-economic status in rising defaults and the notion that what the government is really proposing is a shift in higher education policy that begins to restrict access among populations most at risk of failing to complete and/or repay their loans. The NPRM wants to lay the blame and the responsibility for this shift at the feet of for-profit schools, yet as open access institutions, they are merely vessels of Federal policy, which has allowed a dramatic increase in the number of poorer, working adult students, who also happen to drop-out and default in greater numbers. The path to compliance for most institutions under the newly-proposed Gainful Employment standard will be to restrict access to greater numbers of students seen as poor credit risks, effectively doing the government's dirty work in denying federal benefits to sub-prime borrowers.

This might be regarded as useful fiscal prudence if it was not equally clear that the government would like to direct students formerly attending for-profit programs to state-funded schools. Such an effort was the principal, though failed policy initiative of James Kvaal before he left the White House policy staff to oversee the rulemaking process. Leaving aside the practical issue of how to fund the would-be increases when state budgets are currently so challenged, the government seems to suggest that if the program is inexpensive enough, it matters not at what rate its students drop-out.

In the imagination of most reporters, politicians and, it seems, policy-makers, the typical student is a "kid" heading off to pursue a two- or four-year degree. And in fact this population still makes up the bulk of college attendees as traditional not-for-profit and publicly-funded institutions make up the bulk of colleges and universities. Yet the fastest-growing population has been working adults returning to either complete a degree at the BA level, or begin a degree at the AA level. These are by definition those that have not been successful in school and typically are at greater risk of failing to complete and/or defaulting on their student loans. When the president describes the need to make the nation first again in the number of adults with at least one year of post-secondary education, he is, knowingly or not, describing expanding the number of these individuals enrolled in higher education with their great risk of dropping out and of defaulting.

So while the Department pays lip service to the role of proprietary schools in creating and maintaining capacity necessary to reach the President's ostensible goal of increasing the percentage of Americans with a post-secondary education, in creating a set of rules, adherence to which is both complex and nearly impossible to assess based on simple, available information, it risks discouraging the investment that makes that very capacity possible.

Summary Table Cohort Default Rates

Apollo Group

		Trial 3-Yr CDR	2-Year Cohort Default Rates			
		FY:07	FY:07	FY:06	FY:05	FY:04
University of Phoenix	All Locations	16.0%	9.3%	7.2%	7.3%	7.5%
WIU	Phoenix, AZ (and Axia)	26.5%	18.5%	27.4%	11.4%	5.6%
Total			**10.9%**	**10.9%**	**7.5%**	**7.5%**

Bridgepoint Education

		FY:07	FY:07	FY:06	FY:05	FY:04
Ashford University		17.5%	13.3%	4.1%	4.2%	
University of the Rockies		0.0%	0.0%	0.0%	0.0%	
Total			**13.1%**	**3.9%**	**3.8%**	

Capella

		FY:07	FY:07	FY:06	FY:05	FY:04
Capella University	**Online**	**5.5%**	**2.5%**	**1.5%**	**2.4%**	**2.3%**

Career Education

		FY:07	FY:07	FY:06	FY:05	FY:04
AIU	Hoffman Estates, IL	19.7%	10.6%	8.6%	10.1%	9.2%
CTU	Colorado Springs, CO	22.4%	11.0%	11.3%	9.4%	3.4%
Sanford-Brown Total		21.7%	8.7%	8.3%	13.2%	15.8%
Culinary Total		12.8%	6.0%	5.3%	6.3%	7.3%
IADT Total		17.5%	7.3%	6.7%	12.6%	15.0%
Total		**19.5%**	**9.3%**	**8.4%**	**10.4%**	**10.1%**

Corinthian Colleges

		FY:07	FY:07	FY:06	FY:05	FY:04
Everest Total		31.1%	15.6%	13.5%	10.6%	11.8%
WyoTech Total		19.8%	10.1%	8.6%	9.0%	9.6%
Total		**29.8%**	**14.9%**	**12.9%**	**10.5%**	**11.5%**

DeVry

		FY:07	FY:07	FY:06	FY:05	FY:04
Devry University	All Locations	17.1%	9.0%	7.4%	6.6%	6.6%
Keller Graduate School of Mgmt.	All Locations	4.8%	2.7%	1.4%	1.7%	2.3%
Ross School of Medicine		0.6%	0.3%	0.2%	0.1%	0.3%
Ross School of Veterinary Medicine		0.0%	0.0%	0.2%	0.2%	0.4%
Chamberlain College of Nursing		4.1%	3.0%	1.9%	0.6%	
Apollo College Total		21.1%	7.3%	7.5%	4.9%	
Western Career College		24.5%	10.2%	9.6%	10.4%	
Total		**15.8%**	**7.8%**	**6.4%**	**5.9%**	**6.0%**

Education Management

		FY:07	FY:07	FY:06	FY:05	FY:04
Argosy University	All	5.3%	2.8%	1.3%	1.8%	2.2%
South University	Savannah, GA	16.5%	7.7%	5.6%	3.8%	4.7%
Brown Mackie Average		24.9%	13.1%	10.7%	11.3%	11.1%
Art institute Average		12.6%	6.5%	5.2%	3.9%	4.8%
EDMC Total	**All Locations**	**14.5%**	**7.9%**	**5.5%**	**4.9%**	**5.7%**

Grand Canyon

		FY:07	FY:07	FY:06	FY:05	FY:04
Grand Canyon University	**Phoenix, AZ**	**3.0%**	**2.5%**	**1.6%**	**1.8%**	

ITT Educational Services

		FY:07	FY:07	FY:06	FY:05	FY:04
ITT Total		**24.1%**	**11.6%**	**9.6%**	**9.3%**	**8.5%**

Lincoln Educational Services

		FY:07	FY:07	FY:06	FY:05	FY:04
Lincoln Total		26.0%	13.6%	12.2%	8.6%	8.3%
Briarwood College	Southington, CT	25.4%	23.0%	10.3%	13.9%	
	Average	**27.3%**	**13.7%**	**12.2%**	**8.7%**	**8.3%**

Strayer Education

		FY:07	FY:07	FY:06	FY:05	FY:04
Strayer University	**All Locations**	**13.0%**	**6.1%**	**3.9%**	**3.9%**	**4.5%**

Universal Technical Institute

		FY:07	FY:07	FY:06	FY:05	FY:04
UTI Total		**13.8%**	**6.6%**	**7.2%**	**5.5%**	**8.8%**

Important Disclosures

Analyst Certification

I, Trace Urdan, hereby certify that all of the views expressed in this research report accurately reflect my personal views about the subject securities or issuers. I also certify that no part of my compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this research report.Signal Hill does not compensate its equity research analysts based on specific investment banking transactions. Signal Hill Equity research analysts receive compensation based on several factors, including overall profitability and revenues of the firm, which include investment banking revenues.

Meaning of Ratings

Signal Hill uses a three-tiered rating system defined as follows:

BUY: We expect this stock to outperform its peers over the next 12 months:

HOLD: We expect this stock to perform in line with its peers over the next 12 months:

SELL: We expect this stock to underperform its peers over the next 12 months:

Distribution of Ratings/IB Services
Signal Hill

			IB Serv./Past 12 Mos.	
Rating	**Count**	**Percent**	**Count**	**Percent**
BUY	**85**	**62.5**	**80**	**94.1**
HOLD	**50**	**36.8**	**41**	**82.0**
SELL	**1**	**0.7**	**1**	**100.0**

Disclaimer

This report has been prepared using sources we deem to be reliable but we do not guarantee its accuracy and it does not purport to be complete. This report is published solely for information purposes and is not intended to be used as the primary basis for making investment decisions, which should reflect the investment objectives and financial situation of the investor. The opinions expressed herein are subject to change without notice. This report is not an offer or the solicitation of an offer to buy or sell securities. Additional information is available upon request.