For-Profit Education

Industry Overview

• We see both large opportunities and risks in the for-profit education stocks
This report provides an overview of the for-profit, postsecondary education market. Please read this report in parallel with our initiation report on Apollo Group.

• For-profit education is likely growing at 15–20%, helped by multiple drivers
Many of these companies are helping to meet the needs of working adults, who increasingly need to update their skills to stay competitive. Working students have different needs from traditional students; for-profits are addressing these needs well and are taking share from the traditional schools.

• Online education represents a significant growth opportunity for the for-profits
Only about 4–5% of total postsecondary students are now taking fully online classes, but penetration is rising rapidly. Students are attracted to the increased flexibility that online education provides, and as long as no unscrupulous operators cut corners and undermine the perceived quality of online classes, penetration should grow nicely.

• The business also has high barriers to entry and low cyclicality
Tough regulations restrain would-be new entrants, and the existing schools are likely to continue to consolidate.

• However, demographic drivers are mixed, at best
There are about 50 million adults in the US as the addressable market, and some for-profits are going after the traditional 18-23 year-old students. Many areas that are the focus of for-profit educational programs are rapidly growing, such as healthcare, IT, and management. However, the number of high school graduates will begin to decline in a few years, and the DoE does not expect a mix-shift toward older students.

• Competition is increasing, as the business matures
The cost of new student leads seems to be rising, and marketing expenses will likely outgrow revenues at most of these companies.

• Also, there is no shortage of operational landmines in this business
Regulations are stringent, and consequences can be severe. Also, acquisitive companies face significant integration challenges.

• In-Line view on the Human Resources Services subgroup
We believe the outlook for cyclical staffing stocks is mixed, while the outlook for the best-managed education stocks is positive on a longer-term view.

Source: U.S. Dept. of Education

For-Profits have only a 3% share of students
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For-Profit Education Industry Overview

Summary and Investment Conclusion

We are initiating coverage of the for-profit education industry within the context of our In-Line view on the broader Human Resources Services subgroup. This report provides an overview of the for-profit, postsecondary education market. Please read this report in conjunction with our initiation report on the Apollo Group, *A New Core Holding in Our Coverage Universe*, dated October 18, 2004.

We have initiated coverage of Apollo Group (APOL $68.21, Overweight, target $85), the largest private institution of higher education in the US, and therefore the largest publicly-held, for-profit, postsecondary education company. Our rating on APOL shares is Overweight, since we find the stock’s valuation to be attractive relative to the company’s robust growth and cash flow prospects. APOL stock is up nearly 10,000% since its IPO a decade ago, and although the company’s growth rate is slowing, we believe that the stock will continue to outperform the broader equity market, as well as our Human Resources Services coverage universe. The stock is down about 30% from its recent highs, and we would recommend increasing exposure to the stock on this weakness.

Our price target of $85 is based on our DCF and EVA analyses, and translates into 31 times C2005E EPS, and a price to C2005E free cash flow multiple of 34 times. These multiples seem reasonable to us, given the impressive growth, high return on capital, and strong cash flow.

The risks to our price target include: 1) changes to the regulatory environment, and/or real or perceived legal problems at Apollo or its competitors, 2) rapid deceleration in online enrolments, 3) decrease in Federal financing for student tuition, and 4) rapidly rising advertising costs, likely due to declining student lead flow.

<table>
<thead>
<tr>
<th>Industry — Investment Positives</th>
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<tbody>
<tr>
<td>• Rapid growth by focusing on unmet needs</td>
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<td>• Under-penetrated market opportunities</td>
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<td>• Market share gains from traditional schools</td>
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<th>Industry — Investment Negatives</th>
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<tr>
<td>• Very low population growth</td>
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<td>• Uncertain demographic trends for working adults</td>
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<td>• Increasing competition for student leads</td>
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<td>• Educational quality of the for-profits may suffer from the move online</td>
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<td>• Online education may suffer from potential regulatory or competitive setbacks</td>
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<tr>
<td>• Acquisitive companies face numerous risks</td>
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Investment Positives

Rapid growth by focusing on unmet needs: We believe that the for-profit postsecondary education industry is growing at 15-20%, largely because these companies are meeting the educational needs of working adults. Working adults have very different educational and related support needs from education providers. Working adults want highly focused educational programs that teach them specific skills or give them specific qualifications that will be directly relevant in the current or desired job. These working adults also prefer to learn from instructors who have real-world experience, and they appreciate small class sizes and intensive interaction with instructors. They want the instructors’ and administrators’ goals to be aligned with theirs, especially as it relates to educational quality and job placement rates. They also demand convenient class times, including night and weekend sessions, and convenient locations for their classes, near their workplace or home. From a macro perspective, we believe that the ongoing globalization of the world’s economies will put pressure on workers in developed countries to continuously upgrade their skills, or risk becoming uncompetitive and/or under-employed.

Under-penetrated market opportunities: For-profits have historically ignored the traditional-aged college students, preferring to focus on working adults. That said, fewer and fewer students are following a “traditional” educational path. For-profits are starting to go after these younger students, and early results suggest good traction. We see other market expansion opportunities as well. For example, for-profits have only a 3% share of enrollees at two-year institutions (competing with community colleges), which is in-line with their share of the overall post secondary pool of enrollees. We think that the for-profits are very capable of providing the type of career-enhancing education that is sought by students who have historically attended junior colleges. Also, the for-profits have a very low share, about 1%, of professional degree students, and they are modestly under-represented among graduate students as well.

Online education represents a significant opportunity: Online education is rapidly gaining traction, and may represent the biggest under-penetrated opportunity. Segment-leading schools, such as the University of Phoenix Online, have recently generated enrollment growth of nearly 50%, despite having about 100,000 online students. Including not-for-profit schools, only 4–5% of postsecondary students are now fully online. Online education offers many advantages, and barring regulatory issues or perceptions about deteriorating quality, we expect growth rates to remain high for many years, as a significant portion of the roughly 6.5 million working adult students shift over time to a partly or fully online program. At least so far, the DoE’s Distance Education Demonstration Program has reached surprisingly positive conclusions regarding educational quality and student graduation rates. As this mix-shift plays out, there could be a benefit to the margins of the for-profit companies.

Some demographic trends are positive: There are 50 million people in the US between the ages of 25 and 45 who have a high school diploma but no bachelors degree. This represents a large pool of prospective students for the for-profits. Also, the US economy continues to shift away from manufacturing and toward services. Some of the specific occupations that are benefiting from this trend seem likely to drive demand for for-profit educational services. These sectors and occupations include IT, healthcare, education, business / management, etc.

Market-share gains from traditional schools: For-profits appear to be taking share from traditional schools, partly due to lack of public sector college funding due to higher allocation of educational dollars towards K-12 education. Public tuition rates were up about 10% in 2002, another 14% in 2003, and will likely be up another 10% in the year starting this fall. This represents a $1,400 increase in three years for the average public school. Associate programs take share from community colleges, some of which are perceived to provide bad “customer service” and are less geared toward providing quick, useful certificates and degrees.

Barriers to entry, helped by regulations: The numerous government regulations seem to dampen competition by creating barriers to entry. For example, schools need to be accredited in order for their students to be eligible for Title IV financial aid. Most students use government aid, so it would be expensive for a new entrant to build a school from scratch, without government-supported students during its start-up phase. Also, the online market has barriers to entry, since IT investments can be expensive and complex. Also, traditional schools have cultural and institutional barriers to change, which hinder their ability
to compete with the offline and online offerings of the for-profits.

**Low cyclicality:** Undergraduate education for traditional (young) students is generally non-cyclical, although undergraduate for working adults may be modestly cyclical. However, graduate education seems to be slightly counter-cyclical, since many people decide to upgrade their educations when the economy is soft and employment prospects are relatively poor. Some specific types of programs are cyclical (such as IT), but these can be partly offset by others that are counter-cyclical (such as culinary arts).

**Consolidation opportunities seem plentiful, at least for now:** There are several thousand for-profit schools in the US, although only a small percentage of them offer bachelors or higher degrees. We suspect that there will be good consolidation opportunities for some of the trade-oriented schools for a few years, although the quality of the remaining, private companies is unclear, so acquisitions may pose integration challenges.
Investment Concerns

**Very low population growth:** Demographic trends in the U.S. are not very encouraging for the postsecondary education industry. The number of high school graduates is expected to rise at a low single digit annual rate through 2009, but then begin a long period of modest declines as the "echo boomers" work through the educational system. Some of this will likely be offset by a modest further increase in the percentage of high school students who attend college. However, even with this effect, the number of high school graduates who enter college may be roughly flat from 2010 to 2020.

**Uncertain demographic trends for working adults:** For-profit schools have historically focused on working adults, generally including students aged 25 and older. Historically, there has been a significant aging of the postsecondary school population. In 1970, 28% of undergraduate students were age 25 or older, and this ratio increased to 37% by 1980 and to 43% by 2000. However, trends in more recent years have been negative. Based on forecasts from the Department of Education, it seems as if the aging of the student population may not be a significant driver for growth for the for-profits going forward. This seems counter-intuitive to us, so we believe that this assumption could prove conservative, especially as increasingly relevant programs targeted at working adults potentially expand the size of the market for adult education.

**Increasing competition for student leads:** These for-profit schools are growing rapidly, by opening new schools, offering new programs, and increasing utilization of existing facilities (including through online and hybrid classes). While we believe these for-profits can further penetrate their target market, and take share from traditional schools, we believe that growth rates will slow as the business matures. There seem to be a few red flags already, suggesting that the competition for existing student prospects has become more fierce. For example, the University of Phoenix was recently criticized by the Department of Education for its aggressive recruiting techniques. The DoE report quoted several recruiters who said that there were a decreasing number of student leads available for each of the rapidly growing number of recruiters. Other schools have reported slowing lead flow, partly due to company-specific execution and / or legal issues. However, these situations may also reflect increased competition and increased maturity of the industry. As the industry inevitably matures, we expect the current 4–6% tuition growth rates to come under pressure. This pressure may be accelerated by the move toward online education. Job placement rates for the for-profits have fallen below 90% in recent years, partly due to the economy, but maybe partly due to industry maturation as well.

**Educational quality of the for-profits may suffer from the move online:** Our industry contacts in the traditional postsecondary education sector tell us in no uncertain terms that the quality of many for-profit schools’ education is sub-par. Partly for that reason, students at these schools often have trouble transferring their credits to the traditional schools. Of course, the “quality” issue is debatable, and we note that many for-profits have high graduation and placement rates, as well as strong student feedback. We understand that the Department of Education is considering standardizing the accreditation requirements for online educational programs. This could be a positive, but some companies (such as Apollo Group) are concerned that any new rules may not be sufficiently strict to prevent some unscrupulous competitors from cutting a few corners. If this happens, the perception of the quality of online education could suffer considerably.

**Online education may suffer from potential regulatory or competitive setbacks:** The DoE currently restricts online education programs, primarily through the “50/50” Rule. We assume that these rules are most likely to be loosened in coming years. However, if these rules get loosened only slowly, or not at all, the move towards online education could slow sharply. Also, more than 90% of public schools now offer online education, so the lead established by the larger for-profit schools may come under competitive pressure. Furthermore, loosening of the rules would likely not significantly benefit the companies (including some of the larger, public companies) that are already exempt from the rules, through participation in the DoE’s Distance Education Demonstration Program.

**Acquisitive companies face numerous risks:** Some publicly held, for-profit companies have been aggressive acquirers in recent years, and many of these companies have experienced integration problems. We believe that typical acquisition candidates are smaller, privately held companies that started as proprietary trade schools. Many of these companies may have been aggressively managed,
and their acquisition can create cultural problems, as well as legal and regulatory risk. The aggressive consolidators may have focused too much on prices paid, and near-term earnings accretion achieved, rather than of the quality of assets acquired or on long-term synergies realized. Therefore, as a general rule, we would tend to avoid the stocks of the acquisitive companies.
Market Size and Growth

In this section, we provide a broad overview of the education industry, including the size of the various sub-segments of the business. We also highlight the two key growth drivers we see for the for-profit higher education business: 1) meeting educational needs of working adults, and 2) taking market share away from traditional colleges and universities in the education of recent high school graduates. We discuss the first segment in a lot of detail, since this is likely to be the more relevant driver in the medium term. We discuss the online education opportunity in a later section of this report.

Market Definition and Size

According to the US Department of Education, education represents a nearly $750 billion industry (the second-largest industry after healthcare). Including childcare and pre-kindergarten spending, as well as testing and training, a more broadly defined market may exceed $1 trillion. Post secondary education is currently about a $300 billion business, but only about 40% of this is in the private sector (including non-profits). The for-profit, degree-granting higher education sector is perhaps a $10 billion business, but it is likely growing at about 15–20% per year. If non-degree-granting trade schools were included, the market size may well be much larger, perhaps $20–30 billion. Private education is less significant in the K-12 sector, and for-profit education in this K-12 segment is even less significant (and is not covered within the scope of this report).

Spending on public K-12 education is more than double the spending on public postsecondary education. Given the relatively poor quality of the K-12 education in this country, coupled with many national and local politicians’ pledges to improve the quality of, and support for, education, we see some risk that K-12 spending growth could siphon away funds that might otherwise be available to increase spending on public postsecondary education. Such a funding squeeze could be a positive for the for-profit sector, as it slowly takes market share of traditional-aged college students away from traditional colleges and universities.

The for-profit segment currently represents only 3–4% of total postsecondary educational system enrollments, although these penetration rates are clearly rising, and we expect these penetration rates to rise significantly in coming years. The for-profits have high graduation rates, and they therefore represent 4.8% of degrees granted, as of 2002. For-profits represent 13.1% of associate degrees, 2.0% of bachelor’s degrees, 3.0% of masters degrees, 1.5% of doctoral degrees, and a mere 0.2% of professional degrees. We estimate that the for-profit, degree-granting educational segment represents about $10 billion of annual spending. This is about 3% of total postsecondary spending, or 8–10% of private postsecondary spending.

Exhibit 2
Post Secondary Enrollment by Institution Type

Source: Dept. of Education, 2001 data

Education Spending Was $700+ Billion in 2000–2001

![Pie chart showing education spending by type]

Source: Dept. of Education
Enrollment growth has followed an unusual pattern, with no growth over much of the last decade. This is partly a reflection of high school graduation rates, driven by population growth trends. However, it may also reflect modest counter-cyclicality of higher education. Specifically, we believe that undergraduate education is non-cyclical, or at most, only slightly cyclical. By contrast, graduate education seems to be slightly counter-cyclical. In weak economies, with few interesting job opportunities, workers often consider getting a masters or professional degree, with the hope that by the time they exit school, the job situation will have improved. We suspect that the for-profit sector of the post-secondary education industry is a bit more cyclical than is the overall education sector. Some of the core specialties of many for-profit schools, such as IT education, are fairly sensitive to the state of the economy. This is partly offset by other specialties, such as culinary arts, which may be modestly counter-cyclical. Therefore, depending on each company’s end-market exposure, some will be much more cyclical than others.

Exhibit 3
Enrollment Growth Is Expected to Pick Up

![Enrollment Growth Is Expected to Pick Up](image)

*Source: Dept. of Education*

**Population Growth Will Not Be a Major Driver**
Growth in the number of high-school graduates should be a positive driver for a few more years. However, as the “echo boomer” population works through the system, the Department of Education forecasts that the number of high school graduates will actually begin to decline in 2010, and keep declining for a few years.

Exhibit 4
Trends in the Number of High School Graduates

![Trends in the Number of High School Graduates](image)

*Source: Department of Education*

Fortunately, there has been a steady rise in the percentage of high school graduates who attend college. The widening gap between the earnings of college educated employees and non-college educated employees is a major factor for the trend.

Exhibit 5
Portion of High School Students Attending College, 1960–2003

![Portion of High School Students Attending College, 1960–2003](image)

*Source: Bureau of Labor Statistics*

We expect these trends to continue.
Exhibit 6

**College Enrollment Rates Should Continue to Rise**

<table>
<thead>
<tr>
<th>Year</th>
<th>Enrollment Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>63.90%</td>
</tr>
<tr>
<td>2004</td>
<td>65.29%</td>
</tr>
<tr>
<td>2005</td>
<td>65.74%</td>
</tr>
<tr>
<td>2006</td>
<td>66.19%</td>
</tr>
<tr>
<td>2007</td>
<td>66.64%</td>
</tr>
<tr>
<td>2008</td>
<td>67.09%</td>
</tr>
<tr>
<td>2009</td>
<td>67.55%</td>
</tr>
<tr>
<td>2010</td>
<td>67.98%</td>
</tr>
<tr>
<td>2011</td>
<td>68.43%</td>
</tr>
<tr>
<td>2012</td>
<td>68.88%</td>
</tr>
<tr>
<td>2013</td>
<td>69.33%</td>
</tr>
</tbody>
</table>

Source: Dept. of Education

Net of the population and enrollment rate trends, the number of high school graduates who go on to college should grow by a modest 1-3% though 2008, but will likely be about flat for the subsequent five-year period.

**Demographic Trends of Working Adults Are Mixed Too**

As one would expect, the student population at the for-profits is skewed toward older adults, versus at traditional public and private institutions. In fact, more than half of for-profit students are over age 25, versus about one-third for other schools. Across all students, about two-thirds are under age 25, and this has traditionally meant that two-thirds of the market was to some extent off-limits for the for-profit companies. This is changing, as the for-profits become more relevant for younger, more traditional students.

Historically, there has been a significant aging of the postsecondary school population. In 1970, 28% of undergraduate students were age 25 or older, and this ratio increased to 37% by 1980 and 43% by 2000. However, based on forecasts from the Department of Education, it seems as if the aging of the student population has stabilized, and may not be a significant driver for growth for the for-profits going forward. This seems counter-intuitive to us, so we believe that this assumption could prove conservative, especially as increasingly relevant programs targeted at working adults potentially expand the size of the market for adult education.

The overall US population is growing at about 1.5% per year, including effects from both net births and immigration. Perhaps surprisingly, the percentage of post secondary students who are age 25 or above has actually declined 4–5 percentage points in the last decade, to about 38%. This suggests that the trend toward working-age adults seeking to boost their employment prospects through further education is a modest one. It also reflects near-term growth in high school graduates.

Because of the dearth of births following the baby boom generation, the population of 35–44 year olds is expected to decline modestly over the next 10 years. The population of 30–34 year olds should hold roughly flat, while the population of 25–29 year olds should grow modestly. By contrast, the total workforce should grow by a modest 12% in total over the next decade, and much of that growth will come from the over-55 crowd (who are less interested in further education). That said, as global economies continue to become more tightly linked, we expect labor markets to become more competitive, and this should increase the pressure on workers in developed countries to continuously upgrade their skills in order to remain competitive.
Exhibit 8
Mix of Old vs. Young Students Is Stable

Source: Dept. of Education

Exhibit 9
Age-Mix Changes Should Be Modest

Source: Dept. of Education

The vast majority of post secondary students are enrolled in undergraduate degree programs, rather than graduate or professional degree programs. “Undergraduates” include about 6+ million students who are enrolled in associate degree programs, but there are another 0.4 million who are enrolled in non-degree programs.

Exhibit 10
Enrollment by Degree Level

Source: Dept of Education, 2001 data

Enrollments at for-profit institutions tend to be skewed heavily toward undergraduates, who make up about 90% of students. For-profits have not been very successful in attracting professional degree students, who make up less than 1% of for-profit enrollments, versus 6% of enrollments at private, not-for-profit institutions. For-profits are also a bit under-penetrated in the graduate degree programs, so these represent additional growth opportunities for these companies.

Exhibit 11
For-Profit Enrollments Are Skewed Toward Undergrads

Source: Dept. of Education, 2001 data

For-profits have a 3% share of enrollees at two-year institutions (competing with community colleges), which is in-line with their share of the overall post secondary pool of enrollees. However, unlike for four-year institutions, or for graduate and professional degrees, private, not-for-profit institutions don’t really compete in this segment.
We think that the for-profits are very capable of providing the type of career-enhancing education that are required by students who typically attend junior colleges.

**Exhibit 12**

**Enrollment at Two-Year Institutions: Opportunity to Take Share from Community Colleges**

<table>
<thead>
<tr>
<th>Category</th>
<th>Enrollment</th>
</tr>
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<tbody>
<tr>
<td>Not-for-profit public</td>
<td>5,996,701, 96%</td>
</tr>
<tr>
<td>Not-for-profit private</td>
<td>47,549, 1%</td>
</tr>
<tr>
<td>For-profit</td>
<td>206,329, 3%</td>
</tr>
</tbody>
</table>

Source: Dept. of Education, 2001 data

One of the more positive demographic trends, however, is that minority groups represent an under-penetrated market for the post secondary education sector. The for-profits have done a good job of meeting the needs of this subgroup, and as a result, a disproportionately high percentage of enrollments at the for-profits are minorities.

**Exhibit 13**

**Opportunities for More Minority Enrollment**

Source: Dept. of Education

Bureau forecasts that essentially all of the net job growth over the next decade will come from the service sector. Education and healthcare are expected to be among the fastest-growing portions of the labor force. Healthcare jobs are expected to grow by 34%, while private educational services are expected to grow by 29%. Professional and business services jobs are expected to grow by 30%, and the fastest-growing sub-sectors are expected to be employment services, consulting services, and computer systems design, each up 54%. Jobs in Internet-related information businesses are expected to grow 67%. Growth rates for some large sectors, such as financial services, construction, transportation, and hospitality, are expected to be only in the low to mid teens.

On the flip side, many occupations are expected to decline sharply in the coming decade, including farming, textile manufacturing, word processing, stock clerks, secretaries, etc. We think that many people in these fields will feel pressured to upgrade their skills through education.

Most of these trends are common sense, although we are a bit less bullish on the outlook for IT jobs, given the accelerating outsourcing and offshoring trends. Therefore, we like the for-profits that are exposed to healthcare, but are less optimistic on those that are exposed to IT segments.

**What Do Working Adults Want From Education Providers?**

Working adults have very different educational and related support needs from education providers, relative to traditional students that go from high school directly on to college. Working adults want highly focused educational programs that teach them specific skills or give them specific qualifications that will be directly relevant in the current or desired job. These working adults also prefer to learn from instructors who have real-world experience, and they appreciate small class sizes and intensive interaction with instructors. They want the instructors’ and administrators’ goals to be aligned with theirs, especially as it relates to educational quality and job placement rates. They also demand convenient class times, including night and weekend sessions, and convenient locations for their classes, near their workplace or home. The for-profit education companies have focused on these special needs, and as they have expanded their presence market by market, and more recently through online offerings, they have steadily expanded the size of the for-profit, higher education industry.

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*Please see analyst certification and other important disclosures starting on page 55.*
We can break down the demand drivers for for-profit higher education, among working-age adults, into several buckets: 1) population growth among the relevant age and demographic groups, 2) increased needs for new skills in order for employees to stay employed or make advancements, and 3) increased funding for would-be students, who have previously not been able to afford an education while working.

The National Center for Economic Statistics (a division of the Department of Education) published a report in August 2003 that looked at the trend towards adults seeking post secondary enrollment. Among such students, age 24 or older, about two-thirds described themselves as “employees who study,” meaning that work was their highest priority. The other one-third described themselves as “students who work.” The employees who study were much more likely to be older, married, and have children, versus the students who work. They were also much more likely to attend school part time (76%, versus 32 for the others), and the vast majority of them (87%) work full time, meaning that their income was much higher ($46,000 per year versus $22,000). The employees who study are also much less likely to complete their degrees, and to the extent that the for-profits aggressively try to keep their students enrolled, they likely do a better job of meeting the needs of these busy students than do traditional schools.

**Taking Share from Traditional Colleges and Universities Represents a Good Opportunity**

The rate of growth of high school graduates who enter college will likely be very modest, as discussed above. However, we see a very good opportunity for the for-profit companies to take share away from the traditional schools as it relates to this more traditional-aged enrollee. In fact, only about 25% of students currently follow a “traditional” path (enter college right after graduating from high school, attend full-time, while being supported by parents) toward higher education. By contrast, the vast majority of students deviate from this path in one or more ways. In the industry, these students are referred to as “non-traditional students” or as “working adults.”

As we discussed above, working adults have different needs from traditional students. They have less interest in purely liberal arts, theoretical education, and care more about learning real-world, practical skills. They are generally not interested in having to support highly paid professors who spend most of their time on research activities. They are also not particularly interested in supporting a leafy, manicured campus setting or money-losing sports teams, for that matter. Even among more traditional students, we believe the for-profits have an opportunity to provide a better-tailored educational product to suit the students’ needs. In addition to factors mentioned above, this may include providing better job placement services, a more relevant curriculum, a better value proposition, more flexibility with class schedules (including online classes), etc.

The for-profits generally maintain high job placement rates, typically 85–95%, for several reasons. First, they are very focused on maintaining high rates as a way to recruit new students and maintain high revenue growth. Second, they try to stay very close to labor market trends, much more so than traditional schools. To the extent that they can stay flexible with their programs, they are likely to provide skills that are in demand at any given time. Most for-profits have some type of advisory board that monitors their curriculum and recommends changes to keep it relevant.

The for-profits have aggressively explored the opportunities for online and distance learning, partly as a way to make the educational process more convenient for their students. The for-profits also have more flexibility to invest capital in technology projects such as this, compared to the traditional (and especially public sector) schools. We believe that these investments will further help the for-profits meet the needs of working adults, thereby expanding the market, and to a lesser extent, gaining share from the traditional schools.

**Exhibit 14**

**For-Profit Institutions Are Multiplying**

Change in Number of Institutions, 1997 to 2002

<table>
<thead>
<tr>
<th></th>
<th>For-Profits</th>
<th>Not-For-Profits Private</th>
<th>Not-For-Profits Public</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997</td>
<td>137</td>
<td>34</td>
<td>80</td>
</tr>
<tr>
<td>2002</td>
<td>-40</td>
<td>-16</td>
<td>-34</td>
</tr>
</tbody>
</table>

Source: Dept. of Education
In this context, community colleges have in recent years become increasingly concerned about the competitive threat from the for-profits. For-profit programs are much more focused than those at community colleges, and this is the most stark point of differentiation. However, customer service is also a strong competitive advantage for the for-profits. A report from the Community College Research Center underscored these fears, and it highlighted several interesting trends. First, degree and certificate completion rates are much higher for the for-profits than for the traditional schools. Also, four-year for-profit institutions confer as many associates degrees as they do bachelors degrees. In response to this last point, there is some talk in the traditional educational community that perhaps traditional four-year colleges should begin to offer associates degrees, and that even traditional community colleges should begin to offer bachelors degrees. In some cases, relationships are more cooperative, and many four-year for-profits get many transfer students from community colleges.

Even if the public universities decided to overhaul their educational models to more directly meet the specific needs of working students, they would still run into various money-related bottlenecks. For example, capacity utilization in the public universities is generally very high, and relatively few states have the money available to open new campuses. Some states, such as California, have also taken steps to reduce the number of students who attend existing campuses, since the states generally subsidize the students, and the governments are looking for ways to cut spending. As the economy eventually picks up, we suspect that for political reasons, funding for K-12 education will continue to receive a higher priority than funding for public universities.

In theory, the not-for-profit, private institutions could increase capacity. However, the high-end schools generally do not want to dilute their brands, and they would face resistance to expansion from various internal constituents. On the margin, less prestigious not-for-profits could expand, but by definition, they are not being driven by a profit motive, so their incentives for meeting growing needs are fairly modest. Some non-for-profits could convert to for-profit status, and they may well be encouraged to do so by their own managers, as well as by potential private equity investors.

For-profits represent 13.1% of associate degrees, 2.0% of bachelors degrees, 3.0% of masters degrees, 1.5% of doctoral degrees, and a mere 0.2% of professional degrees. We see opportunities for these shares to rise in each segment.

**Compelling Opportunity to Educate More Adults**

We believe that the ongoing globalization of the world’s economies will put pressure on workers in developed countries to continuously upgrade their skills, or risk becoming uncompetitive and/or under-employed. Consistent with this, a rising percentage of high school graduates are going on to college, and this trend should be a positive for traditional and for-profit schools. However, as we discussed earlier, the number of high school graduates is likely to start declining later this year, so total enrollments into college from high school graduates likely will slow to low single digits growth.

Regarding older adults seeking to upgrade their education, we have not seen any good forecasts for what this is likely to mean for in terms of growth opportunities for schools that focus on educating adult workers. That said, we can explore some basic scenario analyses to try to get some idea of what these trends could imply for incremental growth for the for-profit schools. We also believe that as these for-profit schools expand, and generally try to meet the needs of working adults (though such facilitators as online education), they will stimulate demand from students and therefore increase the size of the market.

In our scenario analysis, we make assumptions about the percentage of the population that has a high school degree and will need to seek an associate and/or bachelors degree, as well as the percent of the population that has a bachelors degree that will need to seek a masters degree. There are...
about 185 million people in the US over age 25, and of those, 83 million are between 25 and 45. Of that population, nearly 50 million people have a high school degree but to not have a bachelor's degree. If 50% of that group were to seek a degree some time in the next 20 years, and the average enrollment lasted four years, that would generate five million adult students. This compares to about 500,000 for-profit enrollees and about 400,000 for-profit graduates per year currently. In other words, if the for-profit sector got all of these incremental adult students, the for-profit segment could expand significantly. Actual data show that there are actually about 6 million enrollments into degree-granting programs per year by those age 25 or older, but most don’t go to for-profits.

If we do a similar analysis for bachelor degree adults who may seek a masters degree, we get another 500,000 students. This is based on about 20 million bachelor degree holders (but without masters or professional degrees) who are between 25 and 45. If we assume that 25% of this group were to seek a masters degree some time in the next 20 years, that would generate 250,000 additional for-profit graduates per year.

Actual Growth by the For-Profits Has Been Impressive

In the last eight years, enrollment growth at the for-profits has taken off. We believe that this largely has been driven by these companies’ aggressive focus on expanding the market for postsecondary education of working adults. Also, this growth was enabled by changes to the Title IV funding rules in 1998, which opened up student loans to many more working adults and to the for-profit schools. Assuming that students continue to have access to sources of funding for tuition costs, we expect that enrollment and revenue growth will continue to be driven by three key factors: 1) campus expansion by the for-profits, facilitated by easy access to capital, including by expanding their program offerings, 2) the ability of the for-profits to meet the educational needs of working adults, and 3) the ability of the for-profits to take share of the market for traditional students.

Will the Federal Government Continue to Sufficiently Fund Student Loans and Grants?

We expect the government to renew the Higher Education Act in the coming months, and we generally believe that funding levels will allow for modest growth in overall postsecondary student levels. However, the share held by the for-profits is so low that we don’t see lack of government funding as a factor limiting the growth rate for the public companies. Please see a more thorough discussion of this topic later in the report.

Source: Dept. of Education
Acquisition Opportunities Should Further Add to For-Profit Growth, but the Pace of Acquisitions May Slow

There are more than 6,000 institutions in the US that meet the requirements of Title IV, and of these, more than 4,000 grant degrees. Even in the for-profit portion of the business, there are several thousand institutions. However, the vast majority of the for-profits are non-degree-granting institutions, which may be less attractive for acquisitions. Also, of the for-profit, degree-granting institutions, a majority provide only associate degrees. Therefore, it seems to us as if the number of high-quality higher education firms that are available may not be as great as some of these companies suggest.

Some of the most acquisitive of the larger for-profit schools, such as Career Education and Corinthian College, typically have dozens of companies on their acquisition radar screen at any given time, with perhaps half a dozen in late stage negotiations. Although acquirers typically look for companies that have a good strategic fit (geographic expansion, entrance into a fast-growing segment, etc.), they also typically are very price sensitive.

We believe (based on our experience in other roll-up situations in other industries) that financially-driven acquisition strategies usually eventually run into problems. Such problems can be due to: 1) too-rapid acquisitions, with insufficient integration, 2) buying increasingly lower-quality companies, to keep the deals accretive, as purchase prices rise, and/or 3) cultural clashes with the acquired companies and managements. Specifically in the education industry, companies also run the risk of acquiring companies that have spotty regulatory compliance track records. These deals can create a lot of value, when integrated correctly an intensively. By contrast, they also run the risk of bringing in less responsible managers, and ultimately creating more regulatory risks for the acquitting company.

Acquisition multiples were historically 5–10x trailing EBITDA, but in recent years these have expanded into the low teens, especially for larger and higher-quality companies.

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**Exhibit 19**

**Title IV Institutions by Type, 2002-2003**

<table>
<thead>
<tr>
<th>Total Degree-granting status and level of institution</th>
<th>Total</th>
<th>United States</th>
<th>Private</th>
<th>Outlying areas</th>
<th>Private</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>Public</td>
<td>Not-for-profit</td>
<td>For-profit</td>
<td>Total</td>
</tr>
<tr>
<td>All institutions</td>
<td>6,508</td>
<td>6,354</td>
<td>2,051</td>
<td>1,921</td>
<td>2,382</td>
</tr>
<tr>
<td>4 years and above</td>
<td>2,551</td>
<td>2,490</td>
<td>632</td>
<td>1,558</td>
<td>300</td>
</tr>
<tr>
<td>At least 2 but less than 4 years</td>
<td>2,194</td>
<td>2,170</td>
<td>1,155</td>
<td>251</td>
<td>764</td>
</tr>
<tr>
<td>Less than 2 years</td>
<td>1,763</td>
<td>1,694</td>
<td>264</td>
<td>112</td>
<td>1,318</td>
</tr>
<tr>
<td>Degree-granting</td>
<td>4,251</td>
<td>4,168</td>
<td>1,712</td>
<td>1,665</td>
<td>791</td>
</tr>
<tr>
<td>4 years and above</td>
<td>2,527</td>
<td>2,466</td>
<td>631</td>
<td>1,538</td>
<td>297</td>
</tr>
<tr>
<td>At least 2 but less than 4 years</td>
<td>1,724</td>
<td>1,702</td>
<td>1,081</td>
<td>127</td>
<td>494</td>
</tr>
<tr>
<td>Less than 2 years</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-degree-granting</td>
<td>2,257</td>
<td>2,186</td>
<td>339</td>
<td>256</td>
<td>1,591</td>
</tr>
<tr>
<td>4 years and above</td>
<td>24</td>
<td>24</td>
<td>1</td>
<td>20</td>
<td>3</td>
</tr>
<tr>
<td>At least 2 but less than 4 years</td>
<td>470</td>
<td>468</td>
<td>74</td>
<td>124</td>
<td>270</td>
</tr>
<tr>
<td>Less than 2 years</td>
<td>1,763</td>
<td>1,694</td>
<td>264</td>
<td>112</td>
<td>1,318</td>
</tr>
</tbody>
</table>

Source: Dept. of Education
On the positive side, we see some potential benefits of consolidation. Specifically, companies can create strong brand names, on a national basis, which can be used to “cross-pollinate” the programs through cross-selling. Consolidation may also delay the inevitable maturation of the business, and may allow for high tuition growth rates, relative to in a more fragmented environment. It is also somewhat faster to expand through acquisitions versus organic growth, but we see this as a less compelling reason than in other industries, since new, organically developed campuses can be profitable in their first year.

**Pricing Growth Has Been Robust, but Seems Likely to Slow Eventually**

Tuition cost inflation has typically been 3–5% per year in the last decade or so, or typically 2–3% in excess of the inflation rate. The Department of Education reports that from 1998 to 2003, tuition costs at public four-year universities rose by 32%, costs at private non-for-profits rose 29%, and at for-profits rose a robust 35%. Tuition rates at for profit four-year institutions average about $11,500, versus $14,500 at not-for profit private institutions and $4,000 for in-state students at public institutions. The “price of attendance” (a more fully loaded cost figure, is for $21,000 at for-profits, versus $24,000 at non-for-profit private institutions and $13,000 for public institutions. Tuition costs at two-year public schools has increased much less rapidly, by 15%, versus by 41% at two-year for-profits.

Interestingly, tuition growth tends to be counter-cyclical. In a weak economy, state budget shortfalls and declining endowment values drive high tuition increases. In this context, we don’t expect tuition pricing to come under pressure in the next year or two.

Education industry participants typically argue that, despite rising costs, an education is still a “good deal”, in that the higher wages associated with higher-skilled jobs generate a good return on money spent on education. We believe that this is generally true, given the wide variation in income levels by educational attainment. However, we think that the current rate of tuition price growth is unsustainable. As these for-profit competitors aggressively add capacity, we think that the business will become more price competitive as it slowly matures. We haven’t seen signs that this is happening yet, however. In the medium term, we also think that tuition growth will be affected by the government’s willingness to increase loan subsidies in line with tuition growth.

An internal rate of return (IRR) analysis suggests that money spent on education is generally worth spending. For example, if we model for a basic scenario for a working adult to seek a bachelors degree through night classes at a typical for-profit institution, we calculate an 18% pre-tax IRR. This assumes $25,000 of spending on education per year for four years, followed by a $20,000 boost to annual income in the year following graduation, growing at 3% per year for the next 30 years. If the income boost were only $10,000, we still get an 11% IRR. For someone who pursues a graduate degree later in life, a realistic scenario yields a 20% pre-tax IRR. That assumes $25,000 of educational costs per year for two years, followed by a $10,000 boost to annual income, growing at 3% per year for the next 20 years. We could haircut the assumptions regarding the boost to earnings, and still conclude that a realistic IRR is nicely in excess of the high single digit pre-tax return that many equity strategists assume that a long-term investment in the equity markets would realize.

Job placement rates by for-profits were historically 90%+, but this has fallen to 85–90% in more recent years. Some of this is likely due to the weaker economic environment since 2000; however, some of it may also reflect a slowly maturing industry. This business has fairly high fixed costs, and the marginal cost per incremental student is fairly low. In that context, if excess capacity were to develop, either due to excessive opening of new offices or due to lack of loan funding, we think that price competition could pick up quickly.

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**Exhibit 20**

**Average Annual Income by Education Level**

An internal rate of return (IRR) analysis suggests that money spent on education is generally worth spending. For example, if we model for a basic scenario for a working adult to seek a bachelors degree through night classes at a typical for-profit institution, we calculate an 18% pre-tax IRR. This assumes $25,000 of spending on education per year for four years, followed by a $20,000 boost to annual income in the year following graduation, growing at 3% per year for the next 30 years. If the income boost were only $10,000, we still get an 11% IRR. For someone who pursues a graduate degree later in life, a realistic scenario yields a 20% pre-tax IRR. That assumes $25,000 of educational costs per year for two years, followed by a $10,000 boost to annual income, growing at 3% per year for the next 20 years. We could haircut the assumptions regarding the boost to earnings, and still conclude that a realistic IRR is nicely in excess of the high single digit pre-tax return that many equity strategists assume that a long-term investment in the equity markets would realize.

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**Source: Dept. of Education**
Online Education Opportunity

We believe that online education represents a significant growth opportunity for the education industry, and we think that we are relatively early in the development of this opportunity. Online education, by being more flexible, seems particularly well suited for older students, and for for-profit providers. This segment may well maintain 25%+ revenue growth for another five years or so. However, we also think that companies will need to develop these new offerings carefully, with a focus on educational quality, to ensure that these more efficiently delivered degrees have value to students, employers, and government regulators. Even if most schools provide high-quality educational services, we think that only one or two aggressive competitors could potentially taint the image of all online degrees. Therefore, while we assume that most for-profits will deliver high growth through online offerings, we are not willing to give the earnings from these online offerings as high of a valuation multiple as the growth forecasts might otherwise justify.

While the flexibility of online education should modestly expand the market for educational services, it may also benefit from a mix-shift away from on ground education. Online and offline offerings are getting integrated, and the profitability of the two models may be similar. Given these considerations, we think that it is appropriate to focus on a given company’s overall growth rate, and not get overly impressed with the growth of the company’s online segment.

Why Is Online Education so Promising?
Meeting Students’ Changing Needs: The profile of the typical college student has been changing in recent years, with a trend toward older students. Even among younger students, more of them hold jobs, have families, and have other responsibilities. Therefore, more than ever, students value flexibility and convenience when seeking an education. Online educational programs meet these needs very well, and therefore have the potential to increase the size of the market for adult (and typical college age) education.

Creating New Opportunities for International Students: Higher education has been an “export” business for US education in recent decades. By offering classes online, it is now much more convenient for international students to receive an American university degree.

What Is the Growth Opportunity?
We believe that online enrollment among the larger, public, for-profit postsecondary schools is currently growing at a rate of 30% or better. For some companies more than others, this growth is coming off of a small base. However, we expect online enrollments to continue to grow at 30%-+ for another 2–3 years. Quite simply, only about 4-5% of the nearly 17 million total postsecondary enrollees are likely to be exclusively online students. The largest eight public, for-profit institutions seem to represent about 25% of those online students, or approaching 200,000 students. Among the remaining online students, we believe that the vast majority are at public institutions. The for-profit, online enrollment number seems like a low base to us, so we assume that high growth rates will be sustainable for the next few years.

Exhibit 21
Students Taking at Least One Online Course

<table>
<thead>
<tr>
<th>Carnegie Classification</th>
<th>Percentage of Students (in all schools)</th>
<th>Percentage of Students (in schools offering online classes)</th>
<th>Total Students Taking an Online Course</th>
</tr>
</thead>
<tbody>
<tr>
<td>Doctoral/Research</td>
<td>6.3%</td>
<td>7.0%</td>
<td>209,512</td>
</tr>
<tr>
<td>Masters</td>
<td>8.5%</td>
<td>10.6%</td>
<td>272,096</td>
</tr>
<tr>
<td>Baccalaureate</td>
<td>6.3%</td>
<td>12.0%</td>
<td>105,917</td>
</tr>
<tr>
<td>Associates</td>
<td>10.8%</td>
<td>13.3%</td>
<td>653,600</td>
</tr>
<tr>
<td>Specialized</td>
<td>6.8%</td>
<td>16.3%</td>
<td>58,123</td>
</tr>
</tbody>
</table>

Source: Sloan Consortium

Exhibit 22
Students Taking All Courses Online

<table>
<thead>
<tr>
<th>Size</th>
<th>Percentage of Students (in all schools)</th>
<th>Percentage of Students (in schools offering online classes)</th>
<th>Total Students Taking All Courses Online</th>
</tr>
</thead>
<tbody>
<tr>
<td>Under 1500</td>
<td>2.5%</td>
<td>6.1%</td>
<td>30,936</td>
</tr>
<tr>
<td>1500 to 2999</td>
<td>3.3%</td>
<td>4.2%</td>
<td>25,910</td>
</tr>
<tr>
<td>3000 to 7499</td>
<td>2.1%</td>
<td>2.3%</td>
<td>65,552</td>
</tr>
<tr>
<td>7500 to 14999</td>
<td>2.3%</td>
<td>2.4%</td>
<td>71,932</td>
</tr>
<tr>
<td>15000+</td>
<td>2.6%</td>
<td>2.7%</td>
<td>136,512</td>
</tr>
</tbody>
</table>

Source: Sloan Consortium

To get a better sense for the long-term growth opportunity, we can perform a market size and opportunity analysis, similar to what we did for overall for-profit education. We generally believe that, due to the increased convenience factor, online education will ultimately result in a higher percentage of adults seeking further education, relative to
penetration rates that would have occurred without the online opportunity. However, our earlier analysis generally assumed that the market for adult higher education would be expanded (by several percentage points of annual growth) due to online business models. This earlier analysis may have been conservative in its assumption of market expansion due to the online convenience, and we have seen some industry estimates that suggest a vast majority of online students would not be students at all if online courses were not available.

Nevertheless, we think that an analysis of the online opportunity should focus on the existing market for adult higher education, and then try to make some estimates for how quickly this market will transition from offline to online classes. To a lesser extent, we think that the online market size analysis should focus on the opportunity to convert 18-24-year-old traditional students from offline to online educational formats. We expect traditional universities to be competitive in the online market for younger students, so we do not see this as a particularly large growth opportunity for the for-profits in the near term.

For our broad analysis of the opportunity for for-profit education, we started with the roughly 50 million U.S. adults aged 25-45 who have a high school diploma, but no college degree. If 50% of that group were to seek a degree some time in the next 20 years, and the average enrollment lasted four years, that would generate five million adult students in any given year. This compares to about 500,000 for-profit enrollees and about 400,000 for-profit graduates per year currently. In other words, if the for-profit sector got all of these incremental adult students, the for-profit segment could expand significantly. Actual data show that there are actually about six million enrollments in degree-granting programs.

If we take the above-described population of 50 million and trim it down further based on likely income and other demographical factors of those who are likely to seek an adult education, we still believe there are at least 25 million addressable “potential students.” About 38% of current postsecondary enrollees are age 25 or above, yielding about 6.5 million adult students currently. We believe that there are less than one million online postsecondary students currently, even including younger students. We believe that a significant percentage of those 6.5 million older students will shift online in coming years. In this context, we believe that online enrollment growth will likely hold at perhaps 25% per year for a few more years, and, given pricing growth of 2-4%, we think that online revenue for the industry could maintain nearly a 30% growth rate. The Sloan Consortium has similar expectations, assuming that online enrollment growth will be much higher at for-profits than at other types of schools. Interestingly, the National Education Association surveys suggest that online education is catching on with the under-25 student population about as fast as it is for older students. If true, this could represent another strong growth prospect for the for-profits.

What Are the Risks and Growth Rate Limiting Factors?

Perceived quality risks. In our view, the primary risk is that a few bad apples in the industry could push growth rates for new online degree programs too quickly, resulting in declining quality standards. If that were to happen, we would expect regulators, employers, and students to sour on the idea of online education, and this could reduce demand even from companies that maintained high quality standards.

Regulatory risks. The DoE currently restricts what percentage of programs and students that can be online versus on campus. This “50/50 Rule” makes an institution ineligible for Title IV funding if: 1) more than 50% of courses are though distance education, 2) more than 50% of students are enrolled via distance education, and/or 3) more than 50% of courses lead to a certificate or diploma. The DoE also has some ongoing tests with some of the for-profit companies that are intended to study the effectiveness of online education. Depending on how the DoE’s assessment of how the Distance Education Demonstration Program progresses, there is a possibility that existing regulations could either be strengthened or loosened. DoE has increased the number of schools in this program from 15 initially in 1998 to 27 more recently, suggesting that it is going well so far. In the short term, reauthorization of the Higher Education Act seems likely to cause some further loosening of the 50/50 Rule, but ultimately, we think that the regulatory situation will be driven by perceptions over online program quality.

Applicability issues. In our view, not all types of classes and degree programs are amenable to online learning. Subjects like business, accounting, computer science and education seem to be teachable online, while hands-on courses such as health and science, as well as vocational training, do not work as well.
Competitive Considerations

For-profits have gained a much larger share of the online market (perhaps 25%) versus the on-ground market (perhaps 5%). That is not to say that for-profits have a permanent lead in online education. In fact, more than 90% of public schools offer online courses, versus 55% for private non-profits, and only 45% for for-profits. Nearly 50% of public schools offer online degree programs, versus roughly 20% for both for-profit and non-profit private schools. That said, we think that the 30% penetration rate reflects some competitive advantages in the online segment for the larger for-profit schools.

Financially strapped public schools are hindered by the capital requirements, even though these schools’ students want the flexibility of online offerings. About half of these public schools offer fully online degrees, and nearly 90% of public schools offer at least a few online courses, but their start-up initiatives (often through a hybrid or blended online/on-ground model) may take some time to drive a meaningful mix-shift in their educational models. Public schools seem primarily motivated by the desire to make education more broadly available, while lowering the costs to deliver the education. That said, costs for online education are not lower than for traditional education, and this situation is unlikely to improve. Also, a study by the Alfred T. Sloan Foundation found that most universities are, at best, only breaking even on their online offerings.

Among the for-profits, we do not view any as having any real technology advantages. However, those that are further along in the development of online programs do have advantages in terms of economies of scale. We also view competitive advantage as being driven by overall management quality, vision, and execution. The for-profits seem to be spending relatively less time on hybrid models, and going more aggressively after purely online models. We have reservations about this, since we think the hybrid model makes sense in many respects.

How Does Online Education Work?

There are a number of business models for online education, most of which involve a mix of online and in-class educational methods. In some cases, the schools offer the same classes in both online and offline formats, and students are free to mix and match. In other cases, some courses are offered fully online, while others are offered fully offline. We expect the large, for-profit
schools to leverage a mixture of formats, to offer maximum flexibility. That said, we believe that online-only formats will become more significant going forward, and we would not rule out the possibility that some completely new, online-only entrants could emerge.

The mix-and-match format works well for the for-profit companies for several reasons. First, these companies already have significant on-ground operations, including classroom activities as well as company administration. These operations can be leveraged through incremental online enrollments. Online enrollments can benefit from the previously established brand name of the on-ground operations, and the absence of such a brand represents a significant barrier to entry for pure online entrants. Also, students that have the flexibility to take a mixture of offline and online classes tend to take more units, and generate more revenue, than other students. Finally, companies with significant on-ground operations may be best positioned to ensure the quality of their online programs, since they would have a good perspective from which to develop programs, evaluate test scores, etc.

Exhibit 25
Definitions of Online Education

<table>
<thead>
<tr>
<th>Proportion of content delivered online</th>
<th>Type of Course</th>
<th>Typical Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>0%</td>
<td>Traditional</td>
<td>Course with no online technology used - content is delivered in writing or orally.</td>
</tr>
<tr>
<td>10 to 29%</td>
<td>Web facilitated</td>
<td>Course which uses web-based technology to facilitate what is essentially a face-to-face course. Might use Blackboard or WebCT to post the syllabus and assignments, for example.</td>
</tr>
<tr>
<td>30 to 79%</td>
<td>Blended/Hybrid</td>
<td>Course that is a blend of the online and face-to-face course. Substantial proportion of the content is delivered online, typically uses online discussions, typically has some face-to-face meetings</td>
</tr>
<tr>
<td>80%+</td>
<td>Online</td>
<td>A course where the vast bulk of the content is delivered online. Typically has no face-to-face meetings.</td>
</tr>
</tbody>
</table>

Source: Sloan Consortium

The online-only business model is a bit difficult, given regulations from the Higher Education Act, including the old 12-Hour Rule and the 50/50 rule. An online-only company would have to forgo Title IV funding, which would sharply limit the pool of potential students. Nevertheless, the 1998 authorization of the Distance Education Demonstration program has allowed some online-only schools to ramp up quickly. Schools that participate in this program, such as Capella University and Walden University, have ramped up nicely. Others, such as Jones International University, have had their growth rates restrained by lack of access to Title IV funding.

Despite the regulatory and student funding challenges of the online-only business model, there are some advantages to this model. As is the case with most online businesses, the cost structure is lower for online schools, given fewer physical locations. Also, online schools are not viewed as much of a competitive threat versus the traditional schools, and this fact makes it easier for online-only schools to recruit full-time faculty of traditional schools as adjunct instructors. Online-only schools also can sign alliances with traditional schools, in which the online schools can leverage the facilities, and even some classes, of the traditional schools.

Marketing and lead generation is somewhat different in purely online businesses. Specifically, we believe that a significant majority of leads for online programs come through Internet channels. While some of these leads come directly from the schools’ websites, many of them come from search engine searches and ads, as well as from bulk emails. Other leads can come from links on education industry websites. Costs for leads can range from about $1 for a click-through on a search engine site, to perhaps $100 for a highly qualified lead from an industry site. While costs per lead are lower in the online model, the lead conversion rates are also lower, so total client acquisition costs are likely similar in the two models.

One might assume that online education would require students to have broadband access, but this is not necessarily the case. In fact, online courses generally do not make much use of streaming video, heavy-duty graphics, etc. As broadband access improves, however, online providers will have an opportunity to upgrade the technology aspect of their offerings, and this could make online education even more competitive versus on-ground.

Is Quality Comparable to Traditional Education?
The question of quality of online education is highly debatable and seems somewhat subjective. We generally believe that the quality of online education is lower than that of traditional classroom-based education. This seems to be common sense, in our view, and we believe that employers do not put nearly as much value on an online degree as on an offline degree from a recognized university. Furthermore, our conversations with academics at traditional schools consistently confirm our suspicions. Academics typically complain about the lack of broadly
enriching courses at online schools. They also complain about the lower quality standards for the teachers, who may not have advanced degrees in the fields in which they are teaching. They also are skeptical of online students’ ability to pick up finer points from the professors and other students. In general, we believe that the courses and credits from for-profits are often not transferable to not-for-profit institutions.

Researchers at the Sloan Consortium (which describes itself as a consortium of institutions and organizations committed to quality online education), propose that there are five keys to creating a high-quality online educational program: 1) learning effectiveness, 2) student satisfaction, 3) faculty satisfaction, 4) cost effectiveness, and 5) access. Also, the Institute for Higher Education Policy, in a report titled *Quality on the Line: Benchmarks for Success in Internet-Based Distance Education*, highlights the following keys to quality in online education:

- The development and maintenance of the technical infrastructure
- Adequate training for faculty and students in technical tools and distance education teaching and learning strategies
- Readily available technical assistance
- Support and interaction between students and faculty and among students
- Engagement of students in tasks that require higher-order thinking skills
- Ongoing evaluation and assessment of the curriculum and teaching/learning processes

However, surveys from Sloan, which could be biased in favor of online education, confirm our suspicion that online education is modestly inferior to traditional educational quality. Some surveys have also suggested that online students spend less time studying, and that they score lower on tests than traditional students. However, respondents to the Sloan survey believed that over the next three years the quality of online education would come to modestly surpass that of traditional education.

Older DoE survey data from 2000 seems to suggest that students view online educational quality as modestly below that of traditional education. However, in a July 2003 second report to Congress on the Distance Education Demonstration program, the DoE reached surprisingly positive conclusions regarding online education. DoE concluded that online education was significantly expanding educational opportunities for would-be students. It concluded that retention and completion (graduation) rates for online programs compared favorably with those of traditional schools, and that these metrics are primarily driven by the quality of the institution, rather than by the mode of delivery of the education. That said, retention is higher for schools that offer both onsite and online courses than it is for purely online schools.
Interestingly, the Sloan Consortium reports that a majority of schools of each type view online education as critical to their growth strategies. However, online education is seen as more critical for associate and doctoral programs than for baccalaureate programs. School participants were also least optimistic on the relative quality of online baccalaureate programs, but were relatively more optimistic on the potential quality of online associate and doctoral programs.

Although students and administrators increasingly accept online education, faculty and employer perceptions still lag a bit. Faculty are quite concerned about educational quality. For faculty, teaching online courses is more time-consuming than for offline courses, and there is also the obvious problem of potential student cheating. A survey from the National Education Association suggests that faculty’s satisfaction with the quality of online education also depends to a great degree on the level of technical support that they and their students receive. Faculty are also concerned about the potential loss of their intellectual property, as well as with bread-and-butter issues such as having to teach more students for less money.

What Is the Margin Opportunity?
We believe that online margins, while currently comparable to on-ground margins, have the potential to expand meaningfully as companies get their programs up to full scale. Mature on-ground operations at well-run companies often have operating margins in the high-30% range. Due primarily to lower rent costs, we believe that online operations could eventually achieve operating margins of 40-45%, or perhaps even higher. Companies that have mixed business models may also be able to save on total marketing costs.

In addition, tuition rates tend to be modestly higher for online courses, despite the lower costs. We are not convinced that this is sustainable, but it could provide further upside to online margins should it prove to be sustainable. Customer acquisition costs seem to be modestly lower for online programs, but we are not convinced that this is sustainable either. Online programs get most of their students from online ads, and do not get many from alliances with high schools. Also, online programs get relatively few leads from low-cost referrals. Online programs tend to have smaller class sizes, but this may be partly due to the start-up nature of many programs, and therefore leverage on the teacher’s salary costs may eventually be a source of positive margin differential for online education.
Regulatory Issues

The Higher Education Act of 1965 and related regulations govern those higher education institutions that participate in the Title IV funding program. Compliance with these regulations is critical for accreditation, and authorization to operate in various states, and it can influence the costs of doing business by controlling the supply of Federal funds. These regulations have been highly successful in shutting down most “diploma mills,” and therefore in ensuring a fairly high quality of higher education.

In the past, regulatory issues have had considerable bearing on the performance of for-profit postsecondary education companies. An adverse ruling or the threat of an investigation from the US Department of Education has had a sharp negative impact on share price in several recent situations, as we will soon discuss. In many cases, these investigations cause overreactions by equity investors, although inadequate compliance has the potential to cause significant problems for these public companies.

Accreditation
Although accreditation is a nongovernmental activity, it is used by the government to help protect the Federal government’s loans to students, as well as to ensure the quality of the US higher educational system. Only those institutions that are accredited by a DoE-recognized accrediting organization are eligible to receive federal assistance for their students. Corinthian College has had recent problems in this regard, as discussed later in this chapter.

The process of accreditation can be fairly exhaustive and time-consuming, and creates barriers to entry for new start-up higher education institutions. For instance, it could take up to two years for a startup to get accredited. Further, new institutions are accredited for a period of only two years (versus five years for older institutions). Even for mature institutions, accreditation is not permanent, and institutions have to seek reaffirmation every five years. New degree programs, and/or new locations for an existing college often require new accreditation reviews. Accreditation also serves the purpose of giving the programs a level of credibility with students and employers.

There are three different types of accrediting agencies:
- Regional accrediting organizations operate in six different regions of the country and review entire institutions. Regional accreditation is accepted nationally as the basis for the recognition of earned credit and degrees for academic purposes.
- National accrediting organizations operate throughout the country and review entire institutions.
- Specialized accrediting organizations also operate through the country, and they review programs as well as some single-purpose operations.

Limits on Title IV Program Funds
The regulations under Title IV define the type of educational programs offered by an institution that qualify for Title IV funds. Further, these regulations limit the amount of funds disbursed to a student in any academic year. An academic year must consist of at least 30 weeks of instructional time, and a minimum of 24 credit hours. Programs such as corporate training, or executive education, do not qualify for funding under Title IV, and the cost has to be borne by students (or their sponsors).

Standards of Financial Responsibility
The Higher Education Amendments of 1992 required the DoE to develop financial responsibility standards for institutions, taking into account operating losses, net worth, operating fund deficits, and asset-to-liability ratios. In November 1997, the standards to determine the viability of financial institutions participating in Title IV funding were further tightened, especially for for-profit providers.

It was determined that the financial health of institutions will be assessed based on three ratios: primary reserve, equity, and net income. The primary reserve ratio is a measure of the financial viability and liquidity of an institution. The net income ratio gauges the ability of an institution to generate surpluses to build reserves for future program initiatives. This ratio is akin to sales turnover. Finally, the equity ratio is a measure of the amount of resources financed by owners’ investments, contributions or accumulated earnings. An institution’s raw scores are converted to strength factors and combined into a composite score.

Institutions with composite scores of 1.5 or above are deemed financially responsible, while those below 1.0 are not allowed to continue to participate in the Title IV programs without providing additional surety. Institutions with composite scores between 1.0 and 1.4 can participate
in Title IV, but only through a new "in the zone alternative," under which they will be subject to special disbursement requirements and enhanced monitoring by DoE. An institution may remain “in the zone” for up to three years.

Most of the public companies have composite scores well above the threshold of 1.5. For instance, as of August 31, 2003, the University of Phoenix had a composite score of 3.0 (which is the maximum achievable). We believe the additional oversight of the DoE provides an extra layer of comfort for investors, and may partly explain the strong balance sheets of the for-profit postsecondary companies. For example, DoE puts restrictions on cash collected for unbilled tuition.

**Student Loan Defaults**

In order to reduce the abuse of Title IV program funding, the government launched the Default Management Initiative in the late 1980s. Since then, 1,200 schools have lost student loan program eligibility. Currently, the DoE requires eligible institutions to maintain a student loan cohort default rate of less than 25% for three consecutive years. An institution’s cohort default rates under the FFEL and FDL programs are calculated on an annual basis as the rate at which student borrowers scheduled to begin repayment on their loans in one federal fiscal year default on those loans by the end of the next federal fiscal year. If the default rates exceed 25%, then the DoE may suspend the institution’s participation in FFEL, FDL or Pell programs.

**Other Title IV Regulations**

**Compensation of representatives.** Title IV regulations prohibit an institution from providing any commission, bonus, or other incentive payments to admissions or financial aid officers based on success in securing enrollments or financial aid. This is intended to reduce conflicts of interest in the recruiting process.

**The 90/10 rule.** This rule says for-profit institutions are ineligible to participate in Title IV programs if the amount of Title IV program funds used by the students or institution to satisfy tuition, fees, and other costs exceeds 90% of the institution’s cash-basis revenues from eligible programs. We believe that this rule may be changed in the near term, such that it may apply to not-for-profits as well, or it could be eliminated altogether.

**Restrictions on distance education.** There are restrictions on the number of courses and students that can be enrolled in distance learning programs. Institutions that have more degree programs than certificate offerings are not eligible to participate in Title IV if more than 50% of courses are by correspondence or 50% of courses are offered via distance education. “Distance” education includes both correspondence and telecommunications offerings.

**Change in ownership or control.** Such changes could trigger recertification by the DoE, re-accreditation, and/or reauthorization by state agencies.

**Administrative capability.** The DoE is required to assess the administrative capability of each institution.

**State Regulations**

Companies typically have to apply for permission to operate in each state, although these regulations generally do not cause much trouble for the companies. Some states’ regulations cover online courses that are made available in their state, even if the company does not have a physical presence in the state.

**Instances of Recent Company-Specific Problems with Regulations and Selected Stock Reaction**

In this section, we describe some of the problems regulation has caused companies in this space and how these problems appear to have affected stocks. In some cases, a mere accusation of running afoul of the rules, let alone actually violating them, can seem to affect stocks adversely. Further, if one company is so affected, other companies in the space can be affected by association.
Although potential outcomes are largely unclear since in many instances the suits and investigations are still pending, worst-case scenarios would include fines, suspension and/or revocation of Title IV eligibility or the return of aid funds. That said, more often than not, accusations and investigations have, to date, rarely resulted in significant punitive action. According to industry experts, those prompted by disgruntled employees in the form of “wrongful termination” suits are quite common and often yield immaterial actual conclusions. This is in part driven by a statute called the “False Claims Act,” which gives private citizens the authority to file suits on behalf of the federal government if they suspect fraud has been committed by a federal contractor or funding recipient. Should the allegations be proven, the filer can collect as much as 25% of penalties paid and/or settlement amounts.

Confirmed Regulatory Violation:
Recruiter compensation. In late 2000, the DoE’s Office of Inspector General opened an inquiry into the structure and administration compensation methods of ITT’s student recruiters at three of its then 67 institutions. DoE regulations prohibit the provision of commissions or bonuses as a sole incentive to recruit students. While the inquiry was pending, all of the company’s schools were barred from receiving new certifications and from making substantive changes such as an extension of course offerings or locations. The institutions were reinstated in January 2002.

Pending Litigation and Investigations:
Student performance and personnel records. In February 2004, ITT disclosed that the Department of Justice (DoJ) had obtained a search warrant and related grand jury subpoenas for 10 of its 77 schools at the time. Documents concerned rates for placement, retention, graduation and attendance as well as recruitment and admission materials, student grades, graduate salaries, and credit transfer records. The stock dropped 33% following the announcement. Subsequently, the Texas regional SEC and the federal SEC launched inquiries into the DoJ’s claims.

Shareholder suits. In July 2004, Corinthian College’s shareholders filed a class action lawsuit charging senior management with SEC violations related to the manipulation of student financial aid records. The suit alleges the company: 1) manipulated aid documents to boost loan amounts available to students, constituting fraud, 2) used the aforementioned funds to boost its revenues and stock price, 3) lacked adequate internal controls and, 4) materially inflated earnings and net income, violating GAAP. The company’s stock price dropped by nearly 50% over the 48 hours following the announcement and has recovered only moderately since.

Employee-sourced shareholder suits. On December 2, 2003, a former Career Education employee accused the company of enrollment padding, providing the basis for a shareholder class action suit in the same month. The shares lost 28% of their value in one day, closing at $39.

The SEC opened a formal probe into the suit’s allegations on June 22, 2004, followed by a DoJ investigation that began September 2, 2004. After a springtime recovery to a high of $69 on June 16, the shares dropped 50% during the course of the summer to a new 52-week low of $34.

Financial aid record investigations. In October of 2002, the California Attorney General initiated an investigation of ITT, which maintains 11 campuses in California, to learn if records were falsified. Grade-point averages,
attendance figures, financial aid records, and employee complaints were examined. ITT did not disclose the investigation until 17 months later when its internal probe concluded there was no wrongdoing. After the disclosure, the stock lost over half its value in only a few weeks.

Exhibit 33
ITT’s Stock Price Plunge Post Spring ’04 Revelations

Source: ILX (Ticker: ESI)

Peripheral Costs
Legal costs. A series of lawsuits followed the DoJ investigation alleging ITT violated SEC regulations by issuing material misrepresentations to the market, thereby artificially inflating its stock price. Legal fees related to the DoJ search and related litigation alone amounted to over $3 million, and non-legal investigation-related costs totaled over $2.6 million.

Recruiter compensation and other. In April 2003, ITT disclosed that the DOE had closed an investigation into how it compensated a recruiter. Although the specifics were not disclosed, much controversy continues to surround the potential for incentive bonus payments to reemerge with increasing competition, which could be a violation of Title IV funding regulations.

Exhibit 34
Guilt-by-Association — An Un-Accused Apollo Falters

Source: ILX (Ticker: APOL)

On July 23, Apollo disclosed that it had settled with the DOE following an audit of its Institute for Professional Development (IPD) programs and a review of its University of Phoenix (UOP) recruiting practices. With respect to the IPD, the company will pay $4.4 million to address noncompliant contractual arrangements with its client institutions. The UOP-related issue drew a $9.8 million fine (the largest ever imposed by the DoE) and no admission of wrongdoing. The DoE filed a lengthy transcript detailing the allegations under review, which point toward aggressive behavior on the part of those supervising the program’s recruiting efforts. Examples include significant pay increases for those with short-term records of high-volume enrollments and virtual “punishments” for those who missed targets. Apollo shares stumbled, down 25% after a moderate recovery previously, over the weeks following the initial disclosure as further details of its recruiting activities and the exact fees to be paid to the DOE became known.

Exhibit 35
Apollo Shares Dropped 25% on DOE Settlements

Source: ILX (Ticker: Apollo)

In September of 1998, the DoE accused Computer Learning Centers of non-compliance with 17 various federal regulations including slow repayment of funds related to non-matriculated students. CLC settled the case by posting a $1.5 million letter of credit to cover the missing refunds, prompting a recovery in the shares. However, on the basis of employee fraud claims, the DoE issued the company a subpoena for records related to its compensation plan for admissions staffers. The lengthy ongoing investigation and a request for the return of $187.7 million in funding related to students considered improperly recruited preceded a liquidation filing in February 2001.
Exhibit 36

CLC Recruiting Violations Bring On Chapter 7...

Source: ILX (Ticker: Apollo)
Tuition Financing: A Key Growth Driver

The government is by far the largest provider of financial aid to postsecondary students, providing perhaps 70% of direct student aid, or about $50 billion. Total student aid is at least $80 billion, and this has more than doubled in the last decade. However, it is not clear whether the government is willing to increase funding at a sufficiently high rate to match rising tuition/room-and-board expenses (especially given rising deficits and national security priorities). Also, tuition costs continue to grow much faster than household income. Therefore, the outlook for government, as well as private sector, sources of funding for students is a critical enabler of growth for the education sector, and the for-profits in particular. Students at for-profits (about 25% of them get all of their funding from government loans) are more dependent on loans than are students at traditional schools.

Evolution of Financial Aid

The existence of private and institutional financial support for college education predates the emergence of federal and state assistance. The cornerstone for the current federal and state aid programs was laid with the passage of Higher Education Act in 1965, which established a guaranteed loan program that has grown into the biggest single source of financial aid.

Financial aid can be divided into three main buckets — 1) grants and/or merit-based scholarships that do not have to be repaid, 2) work-study that requires some form of campus work in exchange for aid, and 3) loans that have to repaid.


Exhibit 37

Milestones in Evolution of Financial Aid

<table>
<thead>
<tr>
<th>Year</th>
<th>Commentary</th>
</tr>
</thead>
<tbody>
<tr>
<td>1944</td>
<td>Serviceman’s Readjustment Act (GI Bill). World War II veterans had their tuition paid, and received monthly subsistence support</td>
</tr>
<tr>
<td>1950</td>
<td>First evidence of need-based financial support. Previously, academic achievement and promise used to be the primary decision factors</td>
</tr>
<tr>
<td>1954</td>
<td>College Scholarship Service (CSS) was formed</td>
</tr>
<tr>
<td>1958</td>
<td>National Defence Student Loan (Perkins) Program which provided Federal matching funds</td>
</tr>
<tr>
<td>1964</td>
<td>College Work-Study Program that authorized funds to institutions which matched 20% of the allocated Federal Title IV guaranteed loans launched. Education Opportunity Grants (now known as Supplemental Educational Opportunity Grants) under the Higher Education Act (HEA)</td>
</tr>
<tr>
<td>1972</td>
<td>Reauthorization of HEA. A Basic Grants Program was added, and the State Student Incentive Grant Program was launched</td>
</tr>
<tr>
<td>1992</td>
<td>Reauthorization of HEA. Limits under Stafford loan program were raised</td>
</tr>
<tr>
<td>1993</td>
<td>Federal Direct Loan program was established</td>
</tr>
</tbody>
</table>

Source: Morgan Stanley, College Board

Exhibit 38

2002-03 Financial Aid for Postsecondary Education = $105 Billion

Source: College Board, Morgan Stanley

Grants

In the 2002-03 period, grants constituted 40% of the total financial aid available to students. If tax credits are included under the broader definition of grants (since they do not have to be repaid), the percentage contribution rises to 45%. Since 1996-97, grants as a percentage of total financial aid have increased, but are still below the level of a decade ago. The loan-to-grant ratio is higher for undergraduate students, who use three times as much loan aid as grant aid. Grants are administered at the federal, state, and institutional level.

The grants supported by the federal government include:

Pell Grants. These are the most popular form of federal grants, and are usually awarded to undergraduate students who have not earned a bachelor’s or professional degree. During 2002-03, 4.8 million students received Pell Grants, with a median average award of $2,420 per applicant. The maximum award was raised by $50 to $4,050 for 2003-04 period. The rate of increase in Pell Grants has not kept pace with surging education costs. The College Board calculates that Pell Grants covered less than 25% of tuition, fees, and room and board expenses at a
public four-year institution in 2002-03. This percentage has steadily fallen from a peak of almost 50% in 1975-76.

**Federal Supplemental Educational Opportunity Grants (FSEOG).** These grants are for undergraduates with exceptional financial need. The FSEOG program began in 1993, and offers Federal funds up to 75% of the total grant. The remaining 25% are provided by the participating institution. The grant is capped at $4,000 per student.

**Leveraging Educational Assistance Partnerships (LEAP).** The LEAP program began as the State Student Inventive Grants in 1972 in 28 states. The current LEAP program was enacted in 1998 to provide matching federal funds to support state need-based postsecondary student grant assistance. Preliminary statistics suggest that the government had provided $66 million in the 2002-03 period.

**State-sponsored grants.** Between 1990 and 2000, the percentage of full-time dependent students receiving state grants increased from 11% to 18% at public two-year institutions, and from 14% to 21% at public 4-year institutions. State grants increased by 10% to $5.6 billion in 2002-03, and have more than doubled in the past decade. Many of the states have initiated merit-based grants, so students who do not qualify for need-based aid have begun to receive state grants. In the past ten years, the proportion of merit-based state grants has increased from 10% to 24%.

**Institutional grant.** In 2002-03, institutional grants totaled $20 billion, representing half of all the grant aid available to students. Institutions use “discounted tuitions” to ensure steady numbers of enrollments, and to attract bright candidates, suggesting that these grants are not always need-based. At public 4-year colleges and universities, almost a quarter of the students receive institutional grants.

**Tax credits.** We can consider federal tax credits to be another form of financial aid. The Tax Reform Act of 1997 added several new education credits, including the Hope Scholarship Credit of up to $1,500 per year. Also, the Lifetime Learning Credit provides up to $2,000 per year. The act also provided for deduction of interest on education-related loans, and also created limited education IRAs. The Tax Relief Act of 2001 provided more incentives, including expanded IRAs (Education Savings Accounts), employer assistance, and additional loan interest deductions.

**Federal Work Study**
Federal Work-Study (FWS) provides part-time jobs for undergraduate and graduate students with financial need. The program encourages community service work and work related to the recipient’s course of study. Under this program, the DoE provides funds to participating institutions to cover 75% of the salaries of the undergraduate and graduate students working part-time. The amount of loans offered under FWS was about $1.2 billion in the 2002-03 academic year.

**Government Sponsored Loan Programs**
In the 2002-03 academic year, federal guaranteed loans accounted for 47% of all the financial aid available for postsecondary education. These loans are critical from the perspective of the institutions involved. In 1999-2000, 44% of all full-time dependent undergraduates or their parents borrowed from non-family sources to help pay for their education, with 43% borrowing through one or more of the federal loan programs. The College Board estimates that $49 billion was given out under the Federal loan program in the 2002-03 period.

There are three main types of Federal sponsored loans:

**Federal Family Education Loan Program (FFEL).** This is a public-private partnership created by Congress in 1965 to deliver and administer guaranteed education loans for students and their parents. Under FFEL, private lenders such as banks, credit unions, and savings and loan associations usually make the loans, which are guaranteed by the federal government.

The FFEL program can be divided into two main buckets: 1) Stafford Loans, and 2) PLUS Loans.

The Stafford loans can be subsidized or unsubsidized by the federal government, and the interest rate is capped at 8.25%. Previously, only students demonstrating financial need could borrow through the Stafford program. These loans were subsidized, meaning that the government paid the interest while the student was in school. The unsubsidized Stafford loan program was open to all full-time dependent students. The maximum loan amount offered under the Stafford programs is $23,000.

The PLUS Loan program provides loans to parents to help them pay the education expenses of a child who is a dependent student enrolled at least half time in an eligible program. The amount under a PLUS loan is capped at the...
cost of attendance minus any other financial aid received by the student.

Separately, the state governments started sponsoring loans in 1995-96 but the total amount disbursed is fairly small, only about 1% of the total financial aid available to students in 2002-03 (see Exhibit 38) There has been talk recently of expanding direct government lending, but this is a politically sensitive issue because many banks profit from the current system.

**Ford Federal Direct Student Loans (FDSL).** Under the Direct Loan program, the government provides the capital for the loans. The FDSL program commenced in 1994, providing 7% of the total new loan volume (FFEL and FDSL combined), and that percentage had increased to about 27% by F2003. The government’s ability to borrow funds at relatively low interest rates, and its ability to contract for low-cost loan servicing make the Direct Loan program less expensive than the subsidies paid to lenders and guaranty agencies in the FFEL program. The types of loans offered under the Direct Loan program are similar to those under the FFEL, with the same terms and conditions.

**Perkins Loan.** A Federal Perkins Loan is a low-interest (5%) loan for both undergraduate and graduate students with financial need, offered at 2,000 participating postsecondary institutions. The Perkins program is structured as a revolving fund, and had assets of $7.2 billion in F2000, according to the DoE. After the reauthorization of the HEA in 1998, undergraduates can borrow $4,000, and graduate and professional students can borrow up to $6,000 per year.

Institutional financial aid administrators at participating institutions have substantial flexibility in determining the amount of Perkins loans to award to students. Under the funding formula, funds are distributed to institutions first, on the basis of the institution’s base guarantee plus the pro rata share received during the 1999-2000 award year under the Perkins Loan Program and, then, on the basis of the aggregate need of the eligible students in attendance. Institutions must contribute 25% of the funding.

### Exhibit 39

<table>
<thead>
<tr>
<th></th>
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<tbody>
<tr>
<td>FFEL</td>
<td>12.5</td>
<td>27.1</td>
<td>30.4</td>
<td>34.6</td>
</tr>
<tr>
<td>FDL</td>
<td>NA</td>
<td>10.9</td>
<td>11.4</td>
<td>13.1</td>
</tr>
<tr>
<td>Perkins</td>
<td>0.9</td>
<td>1.1</td>
<td>1.2</td>
<td>1.3</td>
</tr>
</tbody>
</table>

*Source: College Board*

**Outlook for Federal Funding**

The federal funding cycle is an annual process that includes the earmarking of first authorized funds in variations on the Higher Education Act but also, perhaps as important, proposals for regulation modifications that can have a material impact on the for-profit industry’s market opportunity.

As of publication time, the legislation required to fund federal financial aid programs, the Expanding Opportunities in Higher Education Act (H.R. 3039) for the beginning of the Federal government’s 2005 fiscal year this fall, is still pending in the US Congress. Industry expectations are that final consideration will most likely not take place until next early 2005 (leaving the fall of CY04 funded at FY04 levels in the interim) although there is a small possibility for late 2004. In addition to requesting nearly $57.3 billion for 2005 in loan funding, in line with White House recommendations (and up from $55.7 billion in 2004), the bill specifies a delineation between online and merely correspondence programs, meant to exclude the latter from qualification. The bill includes a proposal to modestly increase the maximum loan amounts for first- and second-year students, although this very expensive provision may get eliminated.

Although not yet currently addressed in the bill, the 50% rule (which requires qualifying institutions to offer no more than half of their coursework online via the Distance Education Demonstration Program) is a topic of debate, with strong support for abolishing or loosening the rule by House Republicans and corporations.

Though in the very early stages, preliminary memos out of the administration’s Office of Management and Budget (OMB) have suggested that the 2006 DoE budget proposal could pare back the nearly $1.7 billion increase in 2005 to just under $0.2 billion. Targeted areas include: Title I state grants (by $340 million), the Pell Grant (by $327 million), Special Education ($309 million) and Vocational Training (by $26 million.) However, administration representatives have indicated that their initial instructions were only preliminary guidelines (normal for this time of year) and far from an actual policy decision. Regardless, the timing for the most relevant stage of the policymaking process is unlikely to take shape until well after the election, or roughly in February of 2005. Also, it is worth noting that similar indications of budget cuts have emerged in prior early administration planning periods during President
George W. Bush’s term that did not materialize in his final proposals.

Also pending in Congress is the College Access and Opportunity Act of 2004 (HR 4283). The bill aims to authorize the transfer of credits from non-accredited programs to qualified institutions. Although, if passed, the legislation would not directly benefit for-profit schools in a pecuniary fashion, the legitimization of their non-accredited programs could accelerate the market shift from not-for-profit. The prospects for passage are mixed.

Because both parties going into the election appear to support early and higher education, we believe it is very likely that the longer-term requirements driven by variables such as demographic change and skills training will be met in the interest of maintaining a competitive domestic labor force.

**Non-Federal Loans: Key to Tuition Rate Increases**

Private loans are becoming a very important part of postsecondary education funding because tuition fees are outpacing the growth in government and institution-sponsored financial aid. These third-party loans increased 45% in 2002-03 to a level of almost $7 billion, representing 7% of the total financial aid available to postsecondary students. Since 1995-96, private loans have multiplied six times, and now represent 13% of the total educational loan volume.

According to a research report prepared by the Institute of Higher Education and Policy (IHEP), the number and diversity of private loan products has increased. IHEP estimates that the number of private loan products grew from 79 in March 1997 to 272 in March 2003, an increase of 244%. Of the 272 products, 67 were available to undergraduates, 113 were available to graduate and professional students, and 92 were available to both groups of students.

Sallie Mae (or SLM Corporation) is the nation’s leading source of funding and servicing support for education loans, and is the largest corporate player in the successful private/public partnership established to finance college for American families. The company was founded in 1973 and provides federally guaranteed student loans originated under the Federal Family Education Loan Program. Since its birth, Sallie Mae has expanded its role from a secondary market for student loans to other aspects of the student loan life cycle, such as default aversion and collections. The company serves more than 7 million borrowers, and manages about $90 billion in student loans.

**Private loans may be key to sustain the steady rate of increase in tuition fees.** Over the 1977-2004 period, tuition, fees, and room and board charges (TFRB) have increased 115% at private four-year institutions, and 75% at public four-year institutions (on an inflation-adjusted basis).

**Indexed Growth in Aid versus Tuition Fees (TFRB)**

More importantly, the “net price” of the TFRB after average grants per student has increased from $4,778 in 1992-93 to $5,418 in 2002-03 (in constant dollar terms).
The net price growth has to be supported by various sources, which include private loans. The federal government continues to wrestle with ballooning budgetary deficits. According to a recent bulletin from the National Association for College Admission and Counseling, President Bush is directing the DoE to issue a budget request for 2006 that reduces support for student financial aid. Hence, the role of private loans will be vital in shaping the landscape for tuition prices.

Source: College Board
Valuation

Publicly held education stocks have generally performed very well in recent years, and not withstanding a more recent pull-back on regulatory, legal, and growth concerns, some of the leading stocks continue to be highly valued by investors. We think that short-term pull-backs like the present one generally represent buying opportunities, but mostly for the high-quality companies that have not been involved in investigations. The stocks of companies that have been involved in these issues have seen significant multiple compression, and we think that this may also represent an opportunity, but only for very risk-tolerant investors. We would be cautious regarding the acquisition-driven companies.

We believe that investors typically focus on forward P/E multiples for valuation purposes. We typically focus on our DCF-based valuations when determining price targets for the companies that we cover (please see our related initiation of coverage report on Apollo). However, for the purposes of looking at historical valuation trends for the entire universe of publicly held companies (most of which we do not cover), we highlight the P/E ranges for each of the companies below.

### Exhibit 43

#### Peer Comparison Table

<table>
<thead>
<tr>
<th>CI Price 10/15/04</th>
<th>Market Cap (million)</th>
<th>P/E C2004E</th>
<th>P/E C2005E</th>
<th>PEG C2005</th>
<th>Price to Trlg sales</th>
<th>Price to Trlg FCF</th>
</tr>
</thead>
<tbody>
<tr>
<td>APOL</td>
<td>$68.21</td>
<td>$12,826</td>
<td>33.4</td>
<td>25.2</td>
<td>1.01</td>
<td>6.77</td>
</tr>
<tr>
<td>COCO</td>
<td>$14.27</td>
<td>$1,289</td>
<td>15.9</td>
<td>14.2</td>
<td>0.69</td>
<td>1.56</td>
</tr>
<tr>
<td>CECO</td>
<td>$28.13</td>
<td>$2,878</td>
<td>15.6</td>
<td>12.4</td>
<td>0.53</td>
<td>1.88</td>
</tr>
<tr>
<td>DV</td>
<td>$20.04</td>
<td>$1,409</td>
<td>22.9</td>
<td>19.6</td>
<td>1.16</td>
<td>1.80</td>
</tr>
<tr>
<td>EDMC</td>
<td>$25.95</td>
<td>$1,903</td>
<td>22.7</td>
<td>18.7</td>
<td>0.94</td>
<td>2.20</td>
</tr>
<tr>
<td>ESI</td>
<td>$35.13</td>
<td>$1,607</td>
<td>19.3</td>
<td>16.2</td>
<td>0.80</td>
<td>2.82</td>
</tr>
<tr>
<td>LAUR</td>
<td>$36.26</td>
<td>$1,660</td>
<td>27.3</td>
<td>22.5</td>
<td>0.99</td>
<td>2.90</td>
</tr>
<tr>
<td>STRA</td>
<td>$110.05</td>
<td>$1,633</td>
<td>40.8</td>
<td>33.0</td>
<td>1.53</td>
<td>7.77</td>
</tr>
<tr>
<td><strong>Average</strong></td>
<td></td>
<td></td>
<td><strong>24.7</strong></td>
<td><strong>20.2</strong></td>
<td><strong>1.0</strong></td>
<td><strong>3.5</strong></td>
</tr>
</tbody>
</table>

Source: FactSet, Morgan Stanley Research

_E_ Morgan Stanley Research estimates for Apollo, consensus estimates for non-rated stocks

Most of the stocks in the for-profit education group underwent sharp declines in valuation multiples in the 1999-2000 time frame due to legal/regulatory concerns. The P/E multiple for the group fell to a low of 10-15 times before rebounding closer to average levels of 20-25 times.

### Apollo Group

APOL has historically been the most richly valued of the education stocks. We think that this reflects the company’s high quality and low risk business model, as well as the highly regarded management team. The stock underwent a sharp correction in the 1999-2000 period, in sympathy with the rest of the market over legal/regulatory concerns. In particular, a _Wall Street Journal_ article raised concerns over potential violations of the “12-hour rule,” which further hurt the stock.

### Career Education

The valuation of CECO shares has been fairly volatile in recent years. After hitting a peak in April, the stock has fallen sharply following negative publicity from regulatory probes.
Corinthian College
Like the other stocks in the sector, COC came under pressure in 1999 and early 2000 following regulatory and legal concerns. More recently, there have been company-specific regulatory and legal issues, and a very sharp decline in the shares.

Education Management
Education Management underwent multiple compression in late 1999, in sync with the whole industry, but has been relatively more stable in the past two years. EDMC shares are trading at the top end of the industry valuation range (excluding APOL). The company has been relatively less affected by legal issues, and the diversity of its programs provides a stable outlook for growth in enrollments.

ITT Educational Services
ESI experienced weakness in 2002 as demand for technology education declined, and after a brief recovery in late 2003, the stock has corrected, and is trading closer to average levels.

Laureate Education
Compared to the rest of the group, LAUR (and its predecessor Sylvan Learning Systems) has held relatively steady. Laureate faces much less regulatory scrutiny as it derives less than 5% of its revenues from Title IV funds. The company has broader international exposure compared to its peers.
Strayer Education

STRA’s multiples have expanded following the change of ownership in May 2001. The company has delivered impressive growth in revenues, and expanded its geographic presence into the states of Tennessee, Pennsylvania, and North Carolina. The growth outlook for Strayer should be helped by the smaller size of its revenue base.
Public Company Summaries

**Background and History of For-Profit Education**

For-profit educational companies have been around for perhaps a century. Until a decade or so ago, these schools were generally viewed as “proprietary” or “trade” schools. They were narrowly focused on providing students with a specific set of skills, typically associated with a trade or craft, such as cosmetology or auto mechanics. Their programs typically lasted less than a year. Some of these schools developed a bad reputation in the 1970s and 1980s, due to fraudulent recruiting practices, very high student loan default rates, and low job placement rates. By 1991, only about 20% of two- and four-year degree granting proprietary schools were regionally accredited.

After the regulatory changes in 1992, some of the higher quality trade schools repositioned themselves into higher quality, accredited institutions of higher education. Some of these schools are still more focused on associate and certificate programs, geared toward specific occupations. However, most of the so-called “diploma mills” were pushed out of business.

Many leading for-profit companies grew rapidly in the early to mid-1990s, with most of them going public during that time (see Exhibit 51). With good access to capital, given the stocks’ generally strong performance, the companies had no problems financing their growth and gaining share in the educational business. Institutions were able to increase efficiencies and margins, enhance facilities and educational programs, and modify programs in a timely way in response to the market. In addition, the capital enabled acquisitions, organic expansion permitted greater market penetration, and curriculum diversification helped generate consistent enrollment growth. Traditional universities such as Colombia, Cornell, Stanford, New York University, and the University of Maryland created for-profit wings in light of the change in higher educational models.

**Exhibit 51**

<table>
<thead>
<tr>
<th>Institution</th>
<th>Formation</th>
<th>IPO</th>
</tr>
</thead>
<tbody>
<tr>
<td>University of Phoenix, APOL</td>
<td>1978</td>
<td>1994</td>
</tr>
<tr>
<td>Career Education</td>
<td>1994</td>
<td>1998</td>
</tr>
<tr>
<td>Education Management</td>
<td>1962</td>
<td>1996</td>
</tr>
<tr>
<td>Corinthian Colleges</td>
<td>1995</td>
<td>1999</td>
</tr>
<tr>
<td>DeVry</td>
<td>1931</td>
<td>1991</td>
</tr>
<tr>
<td>Laureate Education</td>
<td>1999</td>
<td>1996</td>
</tr>
<tr>
<td>Strayer Education</td>
<td>1892</td>
<td>1996</td>
</tr>
<tr>
<td>ITT Educational Services</td>
<td>1976</td>
<td>1994</td>
</tr>
<tr>
<td>Universal Technical Institute</td>
<td>1965</td>
<td>2003</td>
</tr>
</tbody>
</table>

Source: Company Documents

Strayer Education has been a for-profit player for over a hundred years. Younger companies that have grown rapidly through acquisitions include Laureate, formerly Sylvan Learning Systems, Corinthian College, and Career Education. Apollo Group has grown modestly organically.

One important advantage shared by many of the for-profits relates to the emergence of online education.

**Exhibit 52**

<table>
<thead>
<tr>
<th>Online Division, Company</th>
<th>Formation</th>
</tr>
</thead>
<tbody>
<tr>
<td>University of Phoenix Online, APOL</td>
<td>1989</td>
</tr>
<tr>
<td>AIU Online, Career Education</td>
<td>2001</td>
</tr>
<tr>
<td>CTU Online, Career Education</td>
<td>2003</td>
</tr>
<tr>
<td>Art Institute Online</td>
<td>2000</td>
</tr>
<tr>
<td>FMU Online, Corinthian Colleges</td>
<td>2001</td>
</tr>
<tr>
<td>DeVry Online</td>
<td>2000</td>
</tr>
<tr>
<td>Laureate Education</td>
<td>1997</td>
</tr>
<tr>
<td>Strayer Online</td>
<td>1997</td>
</tr>
<tr>
<td>ITT Educational Services</td>
<td>2002</td>
</tr>
</tbody>
</table>

Source: Company Documents

Following, we include a brief summary of each of the top eight publicly held, for-profit, private postsecondary educational institutions. Please see our detailed initiation of coverage report on Apollo Group dated October 18, 2004.
Apollo Group: Best in Class

Company Overview
Apollo Group’s largest division, University of Phoenix, was formed in 1978, with an IPO in 1994. The company has relied on organic growth, delivering stellar results that have consistently exceeded consensus expectations. Apollo also has facilities in Canada, with expansion plans for Mexico during F2005. In total, Apollo schools offer 18 degree programs. The company employs over 15,000 full-time employees, which overlap with 17,000 full and part-time faculty members and, we estimate, close to 5,000 enrollment counselors.

Exhibit 53
Quick Snapshot

<table>
<thead>
<tr>
<th></th>
<th>F2004</th>
<th>F2005E</th>
<th>Long Term</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue ($, mn)</td>
<td>1798</td>
<td>30%</td>
<td>25%</td>
</tr>
<tr>
<td>EPS</td>
<td>$1.82</td>
<td>34%</td>
<td>29%</td>
</tr>
<tr>
<td>Enrolments</td>
<td>255,643</td>
<td>24%</td>
<td>21%</td>
</tr>
<tr>
<td>Campus Locations</td>
<td>82</td>
<td>10%</td>
<td>8-10%</td>
</tr>
<tr>
<td>Composite Score*</td>
<td>3.0</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>% of U.S. Revenues</td>
<td>62%</td>
<td>NA</td>
<td>NA</td>
</tr>
</tbody>
</table>

Exhibit 54
Mix of Degree Enrolments at Apollo = 255,643

- Bachelors: 66%
- Masters: 30%
- Associates: 4%
- Doctoral: 0%

Source: Company Documents

Growth Strategy
The company’s growth strategy revolves around the following key areas:

Establish new campus locations and learning centers.
Management said it believes in the first-mover advantage, and is likely to be aggressive in opening campuses, perhaps at an accelerated rate of 7-9 locations, for the next couple of years. The timing of new campus openings are somewhat affected by regulatory approvals. For instance, management could exceed the target of 7-9 new campus opening in F2005 if Apollo gets the regulatory approval it needs from New York State regulators.

Establish new Institute for Professional Development (IPD) relationships.
IPD plans to enter into additional long-term contracts with private colleges and universities.

Expand educational programs.
The company has a staff of 55 employees involved in the curriculum development process. The launch of newer programs is predicated on the demand for professionals in that area of specialization.

Expand access to programs.
Management said it plans to increase access to the company’s programs through distance education. The FlexNet initiative should help in increasing penetration of the company’s programs. At newer campuses, management said it relies on initiating tried and tested programs to create traction with students. As the campus matures, the company opens learning

Apollo’s schools include the University of Phoenix, the Institute for Professional Development, the College for Financial Planning, and Western International University.

Program offerings. The University of Phoenix offers bachelor’s and master’s degrees in business and bachelor’s degrees in health care services, criminal justice administration and nursing, and master’s program in computer information systems, organizational management.

The biggest concentration of students is in the bachelor’s program, with average program duration of 2.7 years. This provides good visibility for management, in our view.
centers to further increase its penetration in a particular market.

**International expansion.** Apollo is focused on expanding organically in North America via its Canada and Mexico operations, while partnering with and potentially acquiring companies on other continents. In addition to its WIU joint venture in Asia, the company has a roughly $1 million investment in Apollo International, a joint venture covering a small campus in the Netherlands. However, management said the company intends to pursue partnerships rather than further joint ventures in the future.

**Key Regulatory/ Legal Issues**
The company recently reached an agreement with the DoE to settle both the Office of Inspector General audit of IPD client institutions and the University of Phoenix program review. Among other matters, the program review of UOP revolved around the incentive compensation of enrollment advisors. Management decided to settle with the DoE in the interests of shareholders for $9.8 million, rather than engage in a protracted review.
Career Education: Acquisitive Company with Diverse Program Offerings

Company Overview
Career Education is among the fastest-growing companies in the for-profit, postsecondary, education industry. However, much of this growth has come through rapid acquisitions. The company operates 81 college campuses in the US and International regions, including Canada, France, the United Kingdom, and the United Arab Emirates. At the end of July 2004, total student enrollment at the company’s various subsidiaries was about 81,000, with over 20% of in the Online Education Group.

Exhibit 55
Quick Snapshot

<table>
<thead>
<tr>
<th></th>
<th>F2003</th>
<th>F2004E YoY Change (%)</th>
<th>Long Term</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue ($, mn)</td>
<td>1188</td>
<td>44%</td>
<td>20%+</td>
</tr>
<tr>
<td>EPS</td>
<td>$1.19</td>
<td>52%</td>
<td>25.0%</td>
</tr>
<tr>
<td>Enrolments</td>
<td>83,200</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Campus Locations</td>
<td>78</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>Composite Score *</td>
<td>2.6</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>% of U.S. Revenues</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>From Title IV fund</td>
<td>58%</td>
<td>NA</td>
<td>NA</td>
</tr>
</tbody>
</table>

Source: Company Data, Morgan Stanley, E= First Call estimates

* Composite score is a measure of Financial Responsibility as defined by DoE, and ranges from -1.0 to 3.0

Career Education’s schools include American InterContinental University (AIU), Colorado Technical University, Gibbs College, and the Western School of Health and Business Careers.

Program offerings: Career Education has a fairly diverse offering that focuses on visual communications, information technology, business studies, culinary arts, and health education. Some of these disciplines may be somewhat economically sensitive (like IT) but overall, the consolidated growth in degree enrollments should be relatively acyclical, in our view.

Exhibit 56
Proportion of Enrollments by Program, 2003

Source: Career Education

Exhibit 57
Proportion of Enrollments by Level, 2003

Source: Career Education

Growth Strategy: Acquisitions Play a Big Role
The key elements of Career Education’s growth strategy include:

Continuing organic growth at existing campus locations.

Acquiring additional schools. To date, the company has grown primarily through acquisitions, which total 26 to date. Career Education’s target schools demonstrate characteristics that include being the “school of choice,” marketable curricula, and attractive facilities and geographic locations.

Opening new branch campuses. Branch locations build on the presence of existing main campus locations.
Expanding the Online Education Group (OEG). The company has two platforms to offer online education — American InterContinental University Online, and Colorado Technical University. The OEG segment offers 27 degree programs leaving scope for future expansion.

Expanding internationally and recruiting international students. The company acquired a group of schools in France in February 2003, and may pursue that strategy to increase share in International markets.

Multiple Compression Following from Regulatory Concerns
Career Education’s forward P/E multiple has compressed from a peak of about 40 times in late 2003 to a current level of 12 times. In June 2003 US Department of Justice announced an investigation of potentially inflated enrollment and revenue inflation. In addition, management’s guidance for 3Q04 fell slightly short of analyst expectations.

Outstanding Key Regulatory/ Legal Issues
Accreditation actions: AIU has been placed on “warning” status by the member colleges of the Southern Association of Colleges and Schools (SACS). AIU has until December 2004 to provide additional information on compliance matters.

Following a review, the Accrediting Commission for Community and Junior Colleges of the Western Association of Schools and Colleges (ACCJC) placed the Brooks College (owned by Career Education) on Probation pending a review of its progress by October 15, 2004.

Some of the degree programs offered by the Western School of Health and Business Careers are under review by the Accrediting Commission of Career Schools and Colleges of Technology (ACCSCT) for discrepancies in the documents filed during the accreditation process.

The US Department of Justice is conducting an investigation concerning the company, although they have not specified the context of the investigation.

On June 22, 2004, the SEC escalated a preliminary inquiry into a formal investigation about allegations that Career Education inflated enrollment numbers to get a larger portion of Title IV funds.
Corinthian College: Heavy Focus on Acquisitions

**Company Overview**
Corinthian College, Inc. operates 88 schools and colleges in the United States, and 45 colleges and 15 training centers in seven Canadian provinces, as of F2004. Enrollment totaled 64,810, an increase of 50% over last year. In contrast to other for-profit education providers, Corinthian College has strong market penetration in the non-degree postsecondary education market, offering a variety of diploma programs. Close to 82% of net revenues were obtained through federal financial aid programs.

**Quick Snapshot**

<table>
<thead>
<tr>
<th></th>
<th>F2004</th>
<th>F2005E (YoY Change (%))</th>
<th>Long Term</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue ($, mn)</td>
<td>804</td>
<td>21%</td>
<td></td>
</tr>
<tr>
<td>EPS</td>
<td>$0.89</td>
<td>2%</td>
<td>20%</td>
</tr>
<tr>
<td>Enrollments</td>
<td>64,810</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Campus Locations</td>
<td>88</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Composite Score *</td>
<td>2.07</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>% of U.S. Revenues</td>
<td>81%</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>From Title IV fund</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
</tr>
</tbody>
</table>

*Composite score is a measure of Financial Responsibility as defined by DoE, and ranges from -1.0 to 3.0

Corinthian College schools include Bryman College, Florida Metropolitan University (FMU), the National Institute of Technology, and CDI.

**Program offerings.** Corinthian College’s student population is heavily skewed toward healthcare, which should drive stable growth in enrollments. Other degree and diploma programs include business, electronics, information technology, criminal justice, automotive repair, etc. etc. The company’s diploma programs focus on entry-level jobs, and hence may be relatively more susceptible to the economy.

**Growth Strategy: Consolidating the Industry**

The company’s growth strategy revolves around the following key aspects:

**Enhance growth at existing campuses.** One of the focus areas is to acquire, develop and refine curricula based on market research. In F2004, the company successfully adopted 82 programs into existing US schools. The company generates leads through several channels, including television, newspaper, direct mail, and the Internet. In order to cater to increasing demand at an existing location, the company remodels its campuses or relocates them to a larger space.

**Establish additional locations.** The pace of new campus openings has accelerated from a rate of two per year in 1999 to 10 per year by F2004.
Acquisitions are a key growth driver. Of the 133 campus, and 15 training centers, 105 campuses and all the training centers have been acquired.

Expand distance learning and corporate training. The company plans to grow online education by increasing the number of courses offered, adding to the number of campuses offering online courses, and expanding the type of degrees and programs offered online. In the corporate training market, Corinthian acquired a platform in the Canadian market with the acquisition of CDI. Management said it hopes to drive growth in the North American market using CDI as a base.

Key Issues Facing the Company
- The shift toward Internet-based leads has been bumpy. The company hopes to shift from costly TV advertising to cheaper Internet-based leads, which account for 28% of the total flow of leads in F4Q04. However, the conversion rate on Internet-based leads has been weaker than management expectations.
- Attrition increased in F4Q04. Among other factors, the negative impact of the pending lawsuit against FMU appeared to hurt the retention in FMU’s online offering. The company has retained retention specialists to raise retention levels across the organization.

Outstanding Key Regulatory/Legal Issues
On September 20, 2004, the company revealed that the SEC is conducting an informal inquiry regarding the company. The company believes that the inquiry concerns Corinthian’s financial projections, performance and communications with analysts in F2004.

There are putative class action lawsuits outstanding against FMU and Rhodes College that have been filed separately by current and former students. The students allege that FMU concealed the fact that it is not accredited by SACS, and that FMU credits are not transferable to other institutions. Plaintiffs are seeking certification of the lawsuit as class actions.

The California Attorney General is examining some lawsuits previously settled by the company.
DeVry: Cyclical Headwinds

Company Overview
DeVry started as a provider of undergraduate program in electronics in 1931, and introduced a computer information systems curriculum in 1979. Later in the 1980s, the company diversified its program offerings to include business operations and telecom management. The IT program was launched in 1998 in response to the growing need for IT professionals. DeVry boasts a strong and stable management team led by Chairman Dennis J. Keller and President and CEO Ronald Taylor, both of whom have been associated with DeVry for more than three decades.

Exhibit 61
Quick Snapshot

<table>
<thead>
<tr>
<th></th>
<th>F2004</th>
<th>F2005E YoY Change (%)</th>
<th>Long Term</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue ($, mn)</td>
<td>785</td>
<td>6%</td>
<td></td>
</tr>
<tr>
<td>EPS</td>
<td>$0.82</td>
<td>13%</td>
<td>15%</td>
</tr>
<tr>
<td>UG Enrolments</td>
<td>38,306</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Grad Enrolments</td>
<td>10,276</td>
<td></td>
<td></td>
</tr>
<tr>
<td>% of U.S. Revenues</td>
<td>&gt;1.5</td>
<td></td>
<td></td>
</tr>
<tr>
<td>From Govt. Aid</td>
<td>60+%</td>
<td>NA</td>
<td>NA</td>
</tr>
</tbody>
</table>

Source: Company Data, E=First Call Estimates
* Composite score is a measure of Financial Responsibility as defined by DoE, and ranges from -1.0 to 3.0

Devry’s schools include DeVry University, (including the Keller Graduate School of Management), the Becker Conviser Professional Review, and Ross University.

Program offerings. Programs include medical and veterinary medical education, computer technology, electronics, business and medical technology, business administration with concentrations like e-commerce, operations management, and business information systems. For graduate students, the Keller School of Management offers an MBA and Masters’ degrees in Project Management, Human Resources, Telecom Management, and Accounting and Financial Management.

Clearly, DeVry’s enrollments are leveraged to the hiring trends in the technology area, which have been fairly weak in this recession.

Attempts to Diversify Program Enrollments Are a Positive
At the start of F2004, DeVry University introduced three new undergraduate programs — Biomedical Engineering Technology (offered at four campuses), Biomedical Informatics (offered at six campuses), and Health Information Technology (offered at three campuses). The ensuing shift toward more healthcare programs is a positive for the company, although technology is likely to account for a majority of the student enrollments for the next few years.

Online Strategy
DeVry launched its online delivery initiative in F2001 to offer a “mix-and-match” format combining campus with online education, with the intent of adding convenience and flexibility. The Bachelor of Business Administration degree program was the first undergraduate DeVry program to be offered in a fully online format. In F2005 and beyond, the company plans to offer new concentrations in security management and hospitality management as a part of its online bachelor’s degree program in business administration.

Operating Strategy for the Three Main Divisions
DeVry University: The key elements of the long-term strategy include:

- Invigorate growth in enrollment through targeted marketing of high school students, and an enhanced student recruiting process.
- Re-engineer some of the programs to increase student appeal.
- Open six to eight DeVry University Centers (DVUC) per year.
- Extend daytime undergraduate programs to DVUC.
- Also grow the Level II center model, which can support 1,500 students without being anchored to a campus.
- Grow the online business, and focus on the hybrid model.

Ross University: Management plans to increase faculty and facilities to sustain the current momentum in the business. The company is in the process of building a 2,500-seat lecture hall in F2005.

Becker Professional Review. The demand for entry-level accountants is fairly strong, and is a key driver of growth for this division. Further, management plans to capitalize
on the all-time low pass rates in the CFA exams to foster demand for the Stalla review course.

**Outstanding Key Regulatory/Legal Issues**

We believe there are no significant regulatory issues facing DeVry presently, although there is a patent-infringement notice filed by Acacia Research Corporation alleging DeVry infringed upon Acacia’s streaming audio and video patents.

Separately, in June 2004, the company received notification from the US DoE that the company’s “financial responsibility” yielded a composite score of 1.4 for the year ended June 2003. This falls below the threshold of 1.5 necessary to qualify for Title IV funding. As such, the DoE required DeVry to make financial aid disbursements under a “cash monitoring” mode. The company believes that the composite score exceeds 1.5 for the year ended June 2004.
Education Management: Strength in Diversity of Programs

Company Overview
Education Management Corporation is another leader in for-profit, postsecondary institutions, with 67 campuses in 24 states and two Canadian provinces. In contrast to its competitors, the majority of EDMC’s student body seeks art degrees. The company’s capital intensity (capex-to-sales ratio) is relatively high at about 10%, perhaps due to relatively greater fixed investments required for art degrees.

Compared to some of its peers, a higher proportion of EDMC’s students are enrolled in the longer-duration bachelor’s or associates degrees. Hence, there is greater visibility in EDMC’s enrollments, in our view.

Exhibit 62
Quick Snapshot

<table>
<thead>
<tr>
<th></th>
<th>F2004</th>
<th>F2005E</th>
<th>YoY Change (%)</th>
<th>Long Term</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues ($, mn)</td>
<td>853</td>
<td>19%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>EPS</td>
<td>$1.03</td>
<td>21%</td>
<td>20%</td>
<td></td>
</tr>
<tr>
<td>Enrolments</td>
<td>53,073</td>
<td>8%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>% of U.S. Revenues</td>
<td>67 %</td>
<td>NA</td>
<td>NA</td>
<td></td>
</tr>
<tr>
<td>From Govt. Aid</td>
<td>73%</td>
<td>NA</td>
<td>NA</td>
<td></td>
</tr>
</tbody>
</table>

Source: Company Data, E=First Call Estimates

* Composite score is a measure of Financial Responsibility as defined by DoE, and ranges from -1.0 to 3.0

Education Management’s schools include The Art Institutes, Argosy University, South University, and American Education Centers.

Program offerings. Education Management’s programs are concentrated in the media arts, design, fashion, culinary arts, behavioral sciences, health sciences, education, information technology, legal studies and business fields. The diversity in course offerings suggests that EDMC is likely to be relatively less sensitive than its peers to the economic impact of workforce demands in any one market.

Exhibit 63
Proportion of Enrollments by Level, 2003

- Doctoral: 59%
- Master: 27%
- Bachelor: 4%
- Associate: 10%
- Associate: 10%

Source: Company Documents

Online Strategy
The company offers online education through the Art Institute Online (programs in creative field), and the South University (programs in business administration and technology). During the summer term of 2004, 1,940 students took all of their courses online, compared to 888 students during the summer term of 2003. The company plans to develop new online courses for existing schools, and to provide increasing flexibility for its students.

Student Recruitment and Marketing
Referrals account for the biggest portion of new student enrolments at EDMC (see Exhibit 64). The company also relies on Internet, radio, local newspaper, television and print media advertising, telephone campaigns, and direct mail campaigns to attract students. EDMC employs a staff of 135, who make presentations at high schools to promote the Art Institute.
Key Elements of Operating Strategy

Emphasize graduate outcomes and student career advancement. The company works with over 1,200 industry professionals to identify the current and anticipated needs of employers, and to develop suitable degree programs so that it sustains a high placement rate for students. Of the 6,453 students who graduated from the Art Institute in 2003, 88.9% obtained employment in their fields of study. EDMC’s focus on student outcomes helps the company to maintain a high student retention rate, and low cohort default rates.

Develop new school locations. In F2004, the company opened two new start-up campuses, with plans to open five new start-up campuses in F2005. The new start-up campuses are opened as branch locations of an existing campus. Although the focus has been on organic growth, the company is opportunistic in making acquisitions to expand the student base.

Develop new academic programs to meet changing market needs.

Roll out existing programs to newer schools. For instance, in F2004 EDMC rolled out 105 existing educational programs to new schools, and plans to roll out 100 programs in F2005.

Shared service locations. In F2004, management started to combine the facilities and administrative services of some schools located relatively close to each other in “shared service locations”. Management plans to establish 10 shared service locations in F2005. This should be a good driver for operating margins, in our view.
ITT Educational Services: Strong Brand for Technology Education

Company Overview
As the leading provider of technology-oriented postsecondary degrees, ITT Educational Services operates 77 institutes in 30 states providing degree programs in the fields of technology to approximately 38,000 students (as of December 31, 2003). Over 99% of programs offered yield degrees. The remaining diploma programs are under review to become associate programs. Management hopes to raise the number of schools authorized to offer bachelor’s programs from 51 at the end of 2003 to 57 by 2004.

Exhibit 65
Quick Snapshot

<table>
<thead>
<tr>
<th></th>
<th>2003</th>
<th>2004E</th>
<th>YoY Change (%)</th>
<th>Long Term</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues ($, mn)</td>
<td>522.8</td>
<td></td>
<td>19%</td>
<td></td>
</tr>
<tr>
<td>EPS</td>
<td>$1.27</td>
<td></td>
<td>43%</td>
<td>20%</td>
</tr>
<tr>
<td>Enrollments</td>
<td>37,076</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Campus Locations</td>
<td>77</td>
<td></td>
<td>5%+</td>
<td></td>
</tr>
<tr>
<td>Composite Score *</td>
<td>2.8</td>
<td></td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>% of U.S. Revenues</td>
<td>72%</td>
<td></td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>From Govt. Aid</td>
<td>NA</td>
<td></td>
<td>NA</td>
<td>NA</td>
</tr>
</tbody>
</table>

Source: Company Data, E=First Call Estimates
* Composite score is a measure of Financial Responsibility as defined by DoE, and ranges from -1.0 to 3.0

ITT derives about 20% of its revenues from student funding made available under the Private loan programs, which have helped enrollment growth in the past three years. Its exposure to Private loans is higher than the industry average.

ITT’s schools include the School of IT, the School of Electronics Technology, the School of Drafting & Design, the School of Criminal Justice, and the School of Business.

Program offerings. The company offers over 20 degree programs and several diploma programs in Software Application and Programming, Web Development, Computer Drafting and Design, Technical Project Management, and Multimedia, to name a few.

About 39% of ITT’s students are enrolled in IT programs, with an additional 35% enrolled in electronics technology programs (see Exhibit 66). The sharp concentration of students in the IT sector exposes enrollment growth to fluctuations in the economy in general, and to the demand for jobs in the technology sector in particular. However, ITT’s average program duration has increased from 18 months in 1986 to about 27 months currently, which should help increase the visibility, in our view.

Exhibit 66
Proportion of Enrollments by Program, 2003

Source: Company Documents

Online Strategy
ITT is in the first innings of its online expansion strategy. In 2003, ITT started to offer online services in 47 states, up from 36 states in the previous year.

Key Elements of the Business Strategy
Management has a 10-point growth plan, the key aspects of which include:

Enhance results at the Institute level. The company plans to increase enrollments at existing locations, and improve student outcomes (in the form of better placement rates) to increase the appeal for prospective students. Management also plans to expand the availability of existing programs to all locations. In 2003, the company added 181 programs in 47 existing institutes, with the intent of adding 230 programs at 66 existing institutes in 2004.

In addition, the company plans to develop newer programs, focusing on information technology (IT), design, business and/or criminal justice, at the associate, bachelor and master degree levels. Management is also considering developing one or more short-term, non-degree programs of study in 2004.

The company is also increasing the number of its institutes that offer bachelor programs. In 2003, the number of
institutes offering bachelor programs increased to 51, and management is aiming to raise it to 57, by the end of 2004.

**Geographic expansion.** Management drives geographic expansion by a combination of opening new institutions and opening new learning sites (which help to increase the penetration of an existing institute). In the past two years, the company has opened three to four new institutes per year in locations identified by its proprietary methodology. The company supplements its organic efforts by acquiring quality companies, especially to grow its online offering. ITT is also entering into alliances and licensing its curricula to international educators, particularly in China and India.

**Increase Margins by leveraging fixed costs.** Management’s focus is to increase enrollments without incurring a proportionate increase in fixed costs. The company is centralizing management functions, and is in the process of creating operational uniformity across institutes. Further, the shift toward the online delivery model should help margins, in our view. Also, as bachelor’s programs grow into a bigger percentage of the overall mix, margins should get an uplift from the higher revenue per bachelor’s program.

**Outstanding Key Regulatory/Legal Issues**

On February 25, 2004, federal agents executed search warrants at the company’s headquarters, and at ten of the 77 ITT Technical Institutes nationwide. Subpoenas were issued against some of the company’s directors and executive officers. The subpoenas and search warrants seek documents related to placement, retention, graduation and attendance, recruitment and admissions materials, student grades, graduate salaries, transferability of credits to other institutions, and personnel records. Although no charges have been filed, management believes the DoJ may be investigating claims alleging falsification of records related to transferability of credits, student attendance, retention, and the like.

Later, on March 4, the SEC notified the company that it had initiated an inquiry into the allegations being investigated by the DoJ.

The DoE recertified almost all of ITT’s campus groups in 2003, except two that were placed on provisional certification. The reason given was that their Perkins cohort default rates exceeded the threshold of 15%. The company is in the process of ending its participation in the Perkins loan program, which accounts for a small percentage of its revenues.
Laureate Education: International Scale Is a Plus

Company Overview
Laureate Education is the world leader in international higher education. The company was previously known as Sylvan Learning Systems but underwent a change of name to better reflect the focus on postsecondary education. Among the for-profit providers, Laureate possesses the largest scale of business internationally, with a network of 12 campus-based locations in 11 countries, spanning Latin America, Europe, and Asia.

Exhibit 67
Quick Snapshot

<table>
<thead>
<tr>
<th></th>
<th>2003</th>
<th>2004E</th>
<th>YoY Change (%)</th>
<th>Long Term</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues ($, mn)</td>
<td>473</td>
<td>32%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>EPS</td>
<td>$0.89</td>
<td>+49%</td>
<td>20%</td>
<td></td>
</tr>
<tr>
<td>Enrolments</td>
<td>117,100</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Campus Locations</td>
<td>12</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>% of U.S. Revenues</td>
<td>&lt;5%</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>From Govt. Aid</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
</tr>
</tbody>
</table>

Source: Company Data, E=First Call Estimates
* Composite score is a measure of Financial Responsibility as defined by DoE, and ranges from -1.0 to 3.0

Laureate’s schools: The company reports results under two broad divisions — the Campus-based segment, and the Online segment. Some of the schools in the Campus segment include Universidad del Valle de México, Universidad de Las Américas, Universidad Europea de Madrid, and Universidad Interamericana.

The Online Higher Education (OHE) segment operates under Cantor & Associates, Walden E-learning (Walden), and National Technological University (NTU).

Programs: The company offers over 100 career-oriented undergraduate and graduate degree programs in a wide range of fields, including international business, hotel management, health sciences, information technology and engineering.

Online Strategy
Laureate’s online offering is in the early stages of growth. The company’s strategy is to expand online program offerings in disciplines that are experiencing good growth and/or facing professional shortages. Management plans to deepen the penetration of the online offerings within the existing student base. For instance, at Cantor, 32% of the students are enrolled online, with the remaining students enrolled in traditional distance learning programs. NTU was acquired in 2002, and provides Laureate with a strong foothold in the domestic online education market. NTU boasts of a partnership with over 20 major U.S. engineering schools and key Fortune 100 companies, providing ample scope for enrollments to grow from a low base.

The growth in the OHE segment has started to accelerate after a period of restructuring in 2003 during which the company terminated some of the relationships between Cantor and some of the private universities. Those relationships have been replaced with other strategic partners, including Walden University.

Strategic Priorities
Entry into new segments. Although the primary focus for the campus-based business is the 18-22-year-old student, the company entered the working adult market in 2003. Laureate enrolled 1,700 working adults in three locations — Chile, Mexico and Spain. Secondly, the company gained access to the technical vocational segment with the acquisition of UNAB in Chile, which has total enrollment of 5,000 students.

Strengthen presence in existing geographies. In 2003, management expanded and consolidated operations in Latin America. For 2004, the attention will shift to Europe, with an emphasis on building scale by adding new campuses, new products, and expanding segments (like post-graduate programs). As a part of the European expansion strategy, the company intends to grow the Swiss Hospitality business into a real worldwide business.

Entry into new countries. Management is always examining opportunities in newer geographies, and may announce entry into one or two new countries.

Regulations Governing Laureate’s Program Offerings
In the US, Laureate operates distance-based education programs, including online education. Walden and NTU are two of only 26 distance learning institutions qualified to participate in the Distance Education Demonstration Program. The Congress partly lifted the constraints (laid out in the original version of HEA bill) on distance-based education to test the programs for quality and Title IV eligibility. Sixteen participants, including Walden and NTU, received waivers of provisions that prohibit Title IV eligibility at distance learning institutions. At the end of
2003, about 26% of Laureate’s OHE’s revenues were directly tied to Title IV funds.

Separately, the company has obtained the necessary approvals from the applicable agencies in each country to operate the schools. In general, the company works with regulators in each country to ensure that new programs are approved before they are launched.

Because of the company’s limited exposure to Title IV funds, it undergoes relatively less scrutiny. There are no legal or regulatory-related proceedings pertaining to Laureate.

**Other Key Points**
- Student financial aid has not been institutionalized in Chile (about 40% of enrollments). The company piloted some commercial loan programs but the critical part is to assess the credit profile and the repayment rate before private parties can extend loans. While management is not anticipating any breakthroughs in the short term, we believe the creation of sustainable student financial aid can be a significant positive for enrollment growth in Chile.
- The company enjoys a low tax rate of 22% due to the geographic mix of operations, and the favorable tax rates in countries like Chile.
- Laureate’s results can be affected by exchange rate fluctuations.
Strayer Education: Strong Regional Competitor

Company Overview
Strayer Education was founded in 1892 and provides postsecondary education in Pennsylvania, Maryland, Washington, D.C., Virginia, North Carolina, South Carolina, and Tennessee. Since the initial public offering in 1996, the company has grown from eight campuses in one state and Washington, D.C., to 30 campuses in eight states (3Q04).

Exhibit 68
Quick Snapshot

<table>
<thead>
<tr>
<th></th>
<th>2003</th>
<th>2004E</th>
<th>YoY Change (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues ($, mn)</td>
<td>147</td>
<td>25%</td>
<td></td>
</tr>
<tr>
<td>EPS</td>
<td>$2.17</td>
<td>25%</td>
<td>22%</td>
</tr>
<tr>
<td>Enrolments</td>
<td>20,000+</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Campus Locations</td>
<td>27</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>Composite Score *</td>
<td>3.0</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>% of U.S. Revenues From Govt. Aid</td>
<td>55%</td>
<td>NA</td>
<td>NA</td>
</tr>
</tbody>
</table>

Source: Company Data, E=First Call Estimates

* Composite score is a measure of Financial Responsibility as defined by DoE, and ranges from -1.0 to 3.0

Strayer’s primary asset is the Strayer University.

Programs include undergraduate and graduate degree programs in business administration, accounting, information technology, education, and public administration. The enrollments in business/economics and computer information systems account for 85% of the total student population (see following exhibits).

Exhibit 69
Enrollments by Program, Spring 2004

The average length of study is two quarters because the students have prior credits.

Recapitalization in May 2001
In May 2001, the company underwent a $150 million recapitalization and change of control transaction, in which it issued 5.8 million shares of its Convertible Preferred Stock to an investor group consisting of New Mountain Partners LP and DB Capital Investors, LP. The Company used the $150 million, together with approximately $36.4 million of its cash, to repurchase 7.2 million shares of outstanding common stock from then-CEO Ron Bailey, who owned 8.2 million shares.

The current management team under Chairman and CEO Robert Silberman has invested heavily in growth since 2001, generating compounded revenue growth of 23% in that period. We note that there has been some flux in the management ranks over the past few years, including the recapitalization in 2001. Most recently, executive Vice President and COO Scott W. Steffey resigned for personal reasons.

Growth Strategy
Management’s strategy to drive growth revolves around the following key points:

Maintain stable enrollments in mature markets. For campuses that are over three years old (14 campuses in total), the company’s goal is to hold enrolments steady, and drive revenue growth through tuition increases of about 5%.
Open new campuses. The company plans to open four new campuses in 2004 (two were opened in Spring 2004) to strengthen the presence in existing states, and expand into contiguous states as well. It takes 15-18 months for a new campus to turn profitable.

Expand Strayer Online. Enrollments at Strayer Online have grown at a compounded rate of 80% since the inception of the program in 1997. The company has enjoyed good success with the “on-demand” format (started in summer 2001) for course offerings since it provides flexibility to the working adults. Management plans to market the online program to both domestic and international students.

Enrollments in the online university had increased to almost 10,000 by Spring 2004.

Develop corporate alliances. Stay’s evening, weekend, and online courses are designed to be attractive for the education and training needs of employers and their employees. The company has sponsorship and reimbursement agreements with over 90 corporations, and plans to increase such relationships.

Make strategic acquisitions. Management looks to acquire companies that are a good strategic fit with existing curricula, have high accreditation standards, and enhance the company’s geographic presence. Before committing to an acquisition, management evaluates alternative uses of capital for such purposes as organic growth, share repurchases, or dividends.

Key Outstanding Regulatory/Legal Issues
Following the change in ownership in May 2001, the US DoE placed Strayer under provisional certification to receive Title IV funds. This is standard procedure, and the full certification is likely to be reinstated within approximately three years of the change in ownership, barring any inconsistencies in the compliance procedures at the school.
ModelWare is a proprietary framework for financial analysis created by Morgan Stanley Research. This new framework rests on the principles of comparability, transparency, and flexibility, and aims to provide investors with better tools to view the anticipated performance of an enterprise. The result of an 18-month global effort, ModelWare harmonizes the underlying data and calculations in Morgan Stanley models with a broad set of consistently defined financial metrics. Our analysts have populated the database with over 2.5 million data points, based on an extensive taxonomy of more than 3,500 unique metrics and more than 400 Morgan Stanley calculations. The ModelWare framework will also have the flexibility to allow analysts and investors to quickly customize their own analytical approach.

What makes the ModelWare architecture distinctive lies in the separation of data from calculations. Its transparency will permit users to see every component of every calculation, to choose elements or recombine them as they wish without laborious adjustments or recalculation. When choices must be made in defining standard or industry-specific measures, ModelWare defaults to economic logic, rather than favoring one accounting rule over another. This discipline facilitates comparability across sectors and regions. Underlying the ModelWare data is a new set of systems that check the internal consistency of forecast data in each of our analyst’s models.

ModelWare EPS illustrates the approach taken. It represents ModelWare net income divided by average fully diluted shares outstanding. ModelWare net income sums net operating profit after tax (NOPAT), net financial income or expense (NFE), and other income or expense. ModelWare adjusts reported net income to improve comparability across companies, sectors, and regions. These adjustments include the following: We exclude goodwill amortization and items deemed by analysts to be “one-time” events; we capitalize operating leases where their use is significant (e.g., in transportation and retail); and we convert inventory to FIFO accounting when LIFO costing is used. For more information on these adjustments and others, as well as additional background, please see “Morgan Stanley ModelWare (ver. 1.0): A Road Map for Investors,” by Trevor Harris and team, August 2, 2004.
Analyst Certification
The following analysts hereby certify that their views about the companies and their securities discussed in this report are accurately expressed and that they have not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report: Chris Gutek and April Henry.

Important US Regulatory Disclosures on Subject Companies
The information and opinions in this report were prepared by Morgan Stanley & Co. Incorporated and its affiliates (collectively, "Morgan Stanley").

As of September 30, 2004, Morgan Stanley beneficially owned 1% or more of a class of common equity securities of the following companies covered in this report: Apollo Group.

Morgan Stanley & Co. Incorporated makes a market in the securities of Apollo Group.

The research analysts, strategists, or research associates principally responsible for the preparation of this research report have received compensation based upon various factors, including quality of research, investor client feedback, stock picking, competitive factors, firm revenues and overall investment banking revenues.
Stock Ratings
Different securities firms use a variety of rating terms as well as different rating systems to describe their recommendations. For example, Morgan Stanley uses a relative rating system including terms such as Overweight, Equal-weight or Underweight (see definitions below). A rating system using terms such as buy, hold and sell is not equivalent to our rating system. Investors should carefully read the definitions of all ratings used in each research report. In addition, since the research report contains more complete information concerning the analyst’s views, investors should carefully read the entire research report and not infer its contents from the rating alone. In any case, ratings (or research) should not be used or relied upon as investment advice. An investor’s decision to buy or sell a stock should depend on individual circumstances (such as the investor’s existing holdings) and other considerations.

Global Stock Ratings Distribution
(as of September 30, 2004)

<table>
<thead>
<tr>
<th>Stock Rating Category</th>
<th>Coverage Universe</th>
<th>Investment Banking Clients (IBC)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Count</td>
<td>% of Total</td>
</tr>
<tr>
<td>Overweight/Buy</td>
<td>626</td>
<td>34%</td>
</tr>
<tr>
<td>Equal-weight/Hold</td>
<td>848</td>
<td>46%</td>
</tr>
<tr>
<td>Underweight/Sell</td>
<td>353</td>
<td>19%</td>
</tr>
<tr>
<td>Total</td>
<td>1,827</td>
<td></td>
</tr>
</tbody>
</table>

Data include common stock and ADRs currently assigned ratings. For disclosure purposes (in accordance with NASD and NYSE requirements), we note that Overweight, our most positive stock rating, most closely corresponds to a buy recommendation; Equal-weight and Underweight most closely correspond to neutral and sell recommendations, respectively. However, Overweight, Equal-weight, and Underweight are not the equivalent of buy, neutral, and sell but represent recommended relative weightings (see definitions below). An investor’s decision to buy or sell a stock should depend on individual circumstances (such as the investor’s existing holdings) and other considerations. Investment Banking Clients are companies from whom Morgan Stanley or an affiliate received investment banking compensation in the last 12 months.

Analyst Stock Ratings
Overweight (O). The stock’s total return is expected to exceed the average total return of the analyst’s industry (or industry team’s) coverage universe, on a risk-adjusted basis, over the next 12-18 months.
Equal-weight (E). The stock’s total return is expected to be in line with the average total return of the analyst’s industry (or industry team’s) coverage universe, on a risk-adjusted basis, over the next 12-18 months.
Underweight (U). The stock’s total return is expected to be below the average total return of the analyst’s industry (or industry team’s) coverage universe, on a risk-adjusted basis, over the next 12-18 months.
More volatile (V). We estimate that this stock has more than a 25% chance of a price move (up or down) of more than 25% in a month, based on a quantitative assessment of historical data, or in the analyst’s view, it is likely to become materially more volatile over the next 1-12 months compared with the past three years. Stocks with less than one year of trading history are automatically rated as more volatile (unless otherwise noted). We note that securities that we do not currently consider "more volatile" can still perform in that manner.

Unless otherwise specified, the time frame for price targets included in this report is 12 to 18 months. Ratings prior to March 18, 2002: SB=Strong Buy; OP=Outperform; N=Neutral; UP=Underperform. For definitions, please go to www.morganstanley.com/companycharts.

Analyst Industry Views
Attractive (A). The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be attractive vs. the relevant broad market benchmark named on the cover of this report.
In-Line (I). The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be in line with the relevant broad market benchmark named on the cover of this report.
Cautious (C). The analyst views the performance of his or her industry coverage universe over the next 12-18 months with caution vs. the relevant broad market benchmark named on the cover of this report.

Stock price charts and rating histories for companies discussed in this report are also available at www.morganstanley.com/companycharts. You may also request this information by writing to Morgan Stanley at 1585 Broadway, 14th Floor (Attention: Research Disclosures), New York, NY, 10036 USA.
Stock Price, Price Target and Rating History (See Rating Definitions)

Apollo Group (APOL.O) - As of 10/18/04 in USD

Industry: N/A

Volatility (Introduced 3/9/01. Shading indicates "more volatile" (V) rating.)

Stock Rating History: 7/24/01: NR; 10/18/04: NR
Price Target History: 7/24/01: NR; 10/18/04: NR

Source: Morgan Stanley Research
Data Format: MM/DD/YY
Price Target: --
No Price Target Assigned (NA)

Stock Ratings abbreviated as below (effective 3/18/02, ratings appear as Stock Ratings/Industry View):
Stock as of 3/18/02: Overweight (O) Equal-weight (E) Underweight (U) More Volatile (V) No Rating Available (NA)
Stock Ratings prior to 3/18/02: Strong Buy (SB) Outperform (OP) Neutral (N) Underperform (UP) No Rating Available (NA)
Industry View: Attractive (A) In-line (I) Cautious (C) No Rating (NR)
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