IRA SOHN CONFERENCE
Presentation by Steve Eisman
SUBPRIME GOES TO COLLEGE
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Good Afternoon. I would like to thank the Ira Sohn Foundation for the honor of speaking before this audience. My name is Steven Eisman and I am the portfolio manager of the FrontPoint Financial Services Fund. Until recently, I thought that there would never again be an opportunity to be involved with an industry as socially destructive and morally bankrupt as the subprime mortgage industry. I was wrong. The For-Profit Education Industry has proven equal to the task.

The title of my presentation is "Subprime goes to College". The for-profit industry has grown at an extreme and unusual rate, driven by easy access to government sponsored debt in the form of Title IV student loans, where the credit is guaranteed by the government. Thus, the government, the students and the taxpayer bear all the risk and the for-profit industry reaps all the rewards. This is similar to the subprime mortgage sector in that the subprime originators bore far less risk than the investors in their mortgage paper.

In the past 10 years, the for-profit education industry has grown 5-10 times the historical rate of traditional post secondary education. As of 2009, the industry had almost 10% of the enrolled students but claimed nearly 25% of the $89 billion of Federal Title IV student loans and grant disbursements. At the current pace of growth, for- profit schools will draw 40% of all Title IV aid in 10 years.

How has this been allowed to happen?

The simple answer is that they've hired every lobbyist in Washington D.C. There has been a revolving door between the people who work or lobby for this industry and the halls of government. One example is Sally Stroup. She was the head lobbyist for the Apollo Group – the largest for-profit company in 2001-2002. But from 2002-2006 she became Assistant Secretary of Post-Secondary Education for the DOE under President Bush. In other words, she was directly in charge of regulating the industry she had previously lobbied for.

From 1987 through 2000, the amount of total Title IV dollars received by students of for-profit schools fluctuated between $2 and $4 billion per annum. But then when the Bush administration took over the reigns of government, the DOE gutted many of the rules that governed the conduct of this industry. Once the floodgates were opened, the industry embarked on 10 years of unrestricted massive growth.

[Federal dollars flowing to the industry exploded to over $21 billion, a 450% increase.]

At many major-for profit institutions, federal Title IV loan and grant dollars now comprise close to 90% of total revenues, up significantly vs. 2001. And this growth has

driven even more spectacular company profitability and wealth creation for industry executives. For example, ITT Educational Services (ESI), one of the larger companies in the industry, has a roughly 40% operating margin vs. the 7%-12% margins of other companies that receive major government contracts. ESI is more profitable on a margin basis than even Apple.

This growth is purely a function of government largesse, as Title IV has accounted for more than 100% of revenue growth. Here is one of the more upsetting statistics. In fiscal 2009, Apollo, the largest company in the industry, grew total revenues by $833 million. Of that amount, $1.1 billion came from Title IV federally-funded student loans and grants. More than 100% of the revenue growth came from the federal government. But of this incremental $1.1 billion in federal loan and grant dollars, the company only spent an incremental $99 million on faculty compensation and instructional costs – that's 9 cents on every dollar received from the government going towards actual education. The rest went to marketing and paying the executives.

But leaving politics aside for a moment, the other major reason why the industry has taken an ever increasing share of government dollars is that it has turned the typical education model on its head. And here is where the subprime analogy becomes very clear.

There is a traditional relationship between matching means and cost in education. Typically, families of lesser financial means seek lower cost institutions in order to maximize the available Title IV loans and grants – thereby getting the most out of every dollar and minimizing debt burdens. Families with greater financial resources often seek higher cost institutions because they can afford it more easily.

The for-profit model seeks to recruit those with the greatest financial need and put them in high cost institutions. This formula maximizes the amount of Title IV loans and grants that these students receive.

With billboards lining the poorest neighborhoods in America and recruiters trolling casinos and homeless shelters (and I mean that literally), the for-profits have become increasingly adept at pitching the dream of a better life and higher earnings to the most vulnerable of society.

But if the industry in fact educated its students and got them good jobs that enabled them to receive higher incomes and to pay off their student loans, everything I've just said would be irrelevant.

So the key question to ask is – what do these students get for their education? In many cases, NOT much, not much at all.

Here is one of the many examples of an education promised and never delivered. This article details a Corinthian Colleges-owned Everest College campus in California whose students paid $16,000 for an 8-month course in medical assisting. Upon nearing

completion, the students learned that not only would their credits not transfer to any community or four-year college, but also that their degree is not recognized by the American Association for Medical Assistants. Hospitals refuse to even interview graduates.

But let's leave aside the anecdotal evidence of this poor quality of education. After all the industry constantly argues that there will always be a few bad apples. So let's put aside the anecdotes and just look at the statistics. If the industry provided the right services, drop out rates and default rates should be low.

Let's first look at drop out rates. Companies don't fully disclose graduation rates, but using both DOE data, company-provided information and admittedly some of our own assumptions regarding the level of transfer students, we calculate drop out rates of most schools are 50%+ per year. As seen on this table, the annual drop out rates of Apollo, ESI and COCO are 50%-100%

How good could the product be if drop out rates are so stratospheric? These statistics are quite alarming, especially given the enormous amounts of debt most for-profit students must borrow to attend school.

As a result of these high levels of debt, default rates at for profit schools have always been significantly higher than community colleges or the more expensive private institutions.

We have every expectation that the industry's default rates are about to explode. Because of the growth in the industry and the increasing search for more students, we are now back to late 1980s levels of lending to for profit students on a per student basis. Back then defaults were off the charts and fraud was commonplace.

Default rates are already starting to skyrocket. It's just like subprime – which grew at any cost and kept weakening its underwriting standards to grow.

By the way, the default rates the industry reports are artificially low. There are ways the industry can and does manipulate the data to make their default rates look better.

But don't take my word for it. The industry is quite clear what it thinks the default rates truly are. ESI and COCO supplement Title IV loans with their own private loans. And they provision 50%-60% up front for those loans. Believe me, when a student defaults on his or her private loans, they are defaulting on their Title IV loans too.

[Let me just pause here for a second to discuss manipulation of statistics. There are two key statistics. No school can get more than 90% of its revenue from the government and 2 year cohort default rates cannot exceed 25% for 3 consecutive years. Failure to comply with either of these rules and you lose Title IV eligibility. Lose Title IV eligibility and you're company's a zero.

Isn't it amazing that Apollo's percentage of revenue from Title IV is 89% and not over 90%. How lucky can they be? We believe (and many recent lawsuits support) that schools actively manipulate the receipt, disbursement and especially the return of Title IV dollars to their students to remain under the 90/10 threshold.]

The bottom line is that as long as the government continues to flood the for profit education industry with loan dollars AND the risk for these loans is borne solely by the students and the government, THEN the industry has every incentive to grow at all costs, compensate employees based on enrollment, influence key regulatory bodies and manipulate reported statistics – ALL TO MAINTAIN ACCESS TO THE GOVERNMENT'S MONEY.

In a sense, these companies are marketing machines masquerading as universities. And when the Bush administration eliminated almost all the restrictions on how the industry is allowed to market, the machine went into overdrive. [Let me quote a bit from a former employee of BPI.

"*Ashford is a for profit school and makes a majority of its money on federal loans students take out. They conveniently price tuition at the exact amount that a student can qualify for in federal loan money. There is no regard to whether a student really belongs in school, the goal is to enroll as many as possible. They also go after GI bill money and currently have separate teams set up to specifically target military students. If a person has money available for school Ashford finds a way to go alter them. Ashford is just the middle man, profiting off this money, like milking a cow and working the system within the limits of what's technically legal, and paying huge salaries while the student suffers with debt that can't even be forgiven by bankruptcy. We mention tuition prices as little as possible .. this may cause the student to change their mind.*

While it is illegal to pay commissions for student enrollment, Ashford does salary adjustments, basically the same thing. We are given a matrix that shows the number of students we are expected to enroll. We also have to meet our quotas and these are high quotas.

Because we are under so much pressure, we are forced to do anything necessary to get people to fill out an application – our jobs depend on it.

It's a boiler room – selling education to people who really don't want it."

This former employee then gives an example of soliciting a sick old lady to sign up for Ashford to meet his quota.

"The level of deception is disgusting – and wrong. When someone who can barely afford to live and feed kids as it is, and doesn't even have the time or education to be able to enroll, they drop out. Then what? Add $20,000 of debt to their problems – what are they gonna do now. They are officially screwed. We know most of these people will drop out, but again, we have quotas and we have no choice."]

How do such schools stay in business? The answer is to control the accreditation process. The scandal here is exactly akin to the rating agency role in subprime securitizations.

There are two kinds of accreditation -- national and regional. Accreditation bodies are non-governmental, non-profit peer-reviewing groups. Schools must earn and maintain proper accreditation to remain eligible for Title IV programs. In many instances, the for-profit institutions sit on the boards of the accrediting body. The inmates run the asylum.

Historically, most for profit schools are nationally accredited but national accreditation holds less value than regional accreditation. The latest trend of for profit institutions is to

acquire the dearly coveted Regional Accreditation through the outright purchase of small, financially distressed non-profit institutions and then put that school on-line. In March 2005, BPI acquired the regionally accredited Franciscan University of the Prairies and renamed it Ashford University. [Remember Ashford. The former employee I quoted worked at Ashford.] On the date of purchase, Franciscan (now Ashford) had 312 students. BPI took that school online and at the end of 2009 it had 54,000 students.

SOLUTIONS

While the conduct of the industry is egregious and similar to the subprime mortgage sector in just so many ways, for the investment case against the industry to work requires the government to do something -- whereas in subprime all you had to do was wait for credit quality to deteriorate.

So what is the government going to do? It has already announced that it is exploring ways to fix the accreditation process. It will probably eliminate the 12 safe harbor rules on sales practices implemented by the Bush Administration. And I hope that it is looking at everything and anything to deal with this industry.

Most importantly, the DOE has proposed a rule known as Gainful Employment. In a few weeks the DOE will publish the rule. There is some controversy as to what the proposed rule will entail but I hope that the DOE will not backtrack on gainful employment. Once the rule is published in the federal registrar, the industry has until November to try to get the DOE to back down.

The idea behind the gainful employment rule is to limit student debt to a certain level. Specifically, the suggested rule is that the debt service-to-income-ratio not exceed 8%. The industry has gotten hysterical over this rule because it knows that to comply, it will probably have to reduce tuition.

[Before I turn to the impact of the rule, let me discuss what happened last week. There was a news report out that Bob Shireman, the Under Secretary of Education in charge of this process was leaving. This caused a massive rally in the stocks under the thesis that this signaled that the DOE was backing down from gainful employment. This conclusion is absurd. First, of all, inside D.C. it has been well known for a while that Shireman always intended to go home to California after a period of time. Second, to draw a conclusion about the DOE changing its policy because Shireman is leaving presupposes that one government official, one man, drives the entire agenda of the U.S. government.]

I cannot emphasize enough that gainful employment changes the business model. To date that model has been constant growth in the number of students coupled with occasional increases in tuition. Gainful employment will cause enrollment levels to grow less quickly. And the days of raising tuition would be over; in many cases, tuition will go down.

To illustrate the impact of gainful employment, I've chosen 5 companies, Apollo, ESI, COCO, EDMC and the Washington Post. Yes, the Washington Post, whose earnings are all driven by this industry.

Assuming gainful employment goes through, the first year it would impact would obviously be 2011. However, because the analysis is so sensitive to tuition levels per school, it's best to have as much information as possible. So for analytical purposes, we are going to show the impact on actual results in fiscal 2009 and this year's estimates under the assumption that gainful employment was already in effect.

We employ 2 scenarios. Scenario 1 is static. It takes actual results and then reduces tuition costs to get down to the 8% level. Scenario 2 is dynamic. It assumes the same thing as scenario 1 but then assumes the companies can reduce costs by 5%-15%.

Results for each company depend largely on the mix of students, the duration of each degree and the price of tuition at each institution

For each company, I show the results under the two scenarios and the corresponding P/Es. Needless to say, the P/E multiples look quite a bit different under either scenario.

Apollo – In fiscal 2009, the company earned $4.22. The consensus estimate for fiscal 2010 is $5.07. Under scenario 1, fiscal 2009 and the fiscal 2010 estimate get cut by 69% and 57%, respectively. Under scenario 2, it gets cut 50% and 41%, respectively.

ESI – In fiscal 2009, the company earned $7.91. The consensus estimate for fiscal 2010 is $11.05. Under scenario 1, fiscal 2009 turns slightly negative and the fiscal 2010 estimate gets cut by 74%. Under scenario 2, fiscal 2009 declines by 75% and the 2010 estimate gets cut by 53%.

COCO – In fiscal 2009, the company earned $0.81. The consensus estimate for fiscal 2010 is $1.67. Under scenario 1, fiscal 2009 turns negative and the fiscal 2010 estimate gets cut by 94%. Under scenario 2, fiscal 2009 declines by 79% and the 2010 estimate gets cut by 38%.

EDMC -- In fiscal 2009, the company earned $0.87. The consensus estimate for fiscal 2010 is $1.51. Under scenario 1, fiscal 2009 and the fiscal 2010 estimate turns massively negative. Under scenario 2, fiscal 2009 and the fiscal 2010 estimate are also massively negative, just less massively than scenario 1. The principal reason why the numbers are so bad for EDMC is that they have a lot of debt and that debt has to be serviced and cannot be cut.

Washington Post – The Post's disclosure of Kaplan metrics is slight. Thus, analyzing the impact from gainful employment is much more difficult and we have confined our analysis solely to fiscal 2009. In fiscal 2009, WPO earned $9.78. Under scenario 1, a loss of $33.25 per share occurs. Under scenario 2, there is still a loss of $6.19. The

principal reason why the numbers are so bad for the Post is that more than 100% of its EBIDTA comes from this industry through its Kaplan division.

[Let me just add one caveat to our analysis. Implementation of gainful employment could result in a cut in marketing budgets. Given the high drop out rates of this industry any such cuts could turn a growth industry into a shrinking industry. The numbers that I just showed do not assume that the industry shrinks but grows at a slower pace.]

Under gainful employment, most of the companies still have high operating margins relative to other industries. They are just less profitable and significantly overvalued. Downside risk could be as high as 50%. And let me add that I hope that gainful employment is just the beginning. Hopefully, the DOE will be looking into ways of improving accreditation and of ways to tighten rules on defaults.

Let me end by driving the subprime analogy to its ultimate conclusion. By late 2004, it was clear to me and my partners that the mortgage industry had lost its mind and a society-wide calamity was going to occur. It was like watching a train wreck with no ability to stop it. Who could you complain to? -- The rating agencies? – they were part of the machine. Alan Greenspan? – he was busy making speeches that every American should take out an ARM mortgage loan. The OCC? -- its chairman, John Dugan, was busy suing state attorney generals, preventing them from even investigating the subprime mortgage industry.

Are we going to do this all over again? We just loaded up one generation of Americans with mortgage debt they can't afford to pay back. Are we going to load up a new generation with student loan debt they can never afford to pay back. The industry is now 25% of Title IV money on its way to 40%. If its growth is stopped now and it is policed, the problem can be stopped. It is my hope that this Administration sees the nature of the problem and begins to act now. If the gainful employment rule goes through as is, then this is only the beginning of the policing of this industry.

But if nothing is done, then we are on the cusp of a new social disaster. If present trends continue, over the next ten years almost $500 billion of Title IV loans will have been funneled to this industry. We estimate total defaults of $275 billion, and because of fees associated with defaults, for profit students will owe $330 billion on defaulted loans over the next 10 years.

[Bracketed Sections might be deleted during the verbal speech because of lack of time.]