Archived Information

## STATEMENT OF HOWARD BLOCK BEFORE THE SECRETARY OF EDUCATION'S COMMISSION ON THE FUTURE OF HIGHER EDUCATION

**M E M O R A N D U M**

To: The Commission on the Future of Higher Education

From: Howard Block Ph.D., Managing Director, Senior Research Analyst Education Services, Banc of America Securities LLC

Re: The State of Higher Education Today: Innovation

Date: February 7, 2006

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Good afternoon

My name is Howard Block.

I work as an equity analyst at Banc of America Securities in San Francisco. My employer was once *Montgomery Securities*, one of the more distinguished, boutique investment firms that were founded in San Francisco in the 1970's. Bank of America acquired Montgomery Securities in 1999.

As an equity analyst, I am responsible for covering companies in the education services sector and writing frequent, brief analyses on individual companies, the sector, and industry sub-groups. I try to describe the businesses and the companies' investment potential, usually from a fundamental analysis standpoint. I get my information by studying public records of the companies and by participating in public conference calls where I can ask direct questions to the management. Previously, analysts were said to obtain lots of information via exclusive meetings with upper management. Regulation FD (Fair Disclosure), is said to prevent most of this from happening at present. I attempt to maintain independent sources of information and contacts and I am obliged to respond timely to breaking news developments on companies throughout the sector.

I became an equity analyst after following a circuitous path that was somewhat uncommon, but certainly not unfortunate. I offer this background only to help you understand my frame of reference.

I began studies at Stanford University in education policy in 1992. I was extremely fortunate as Professor Michael Kirst, who some of you certainly know, took me under his wing and enabled

me to successfully complete my doctorate by 1996. My PhD work was not about equity analysis, but about state and federal policymaking. I studied the effects of state law on the creation of charter schools in an attempt to see if variation in policy across the states was affecting the supply of charter schools in those states.

My research question at Stanford was far different from the one presented to this distinguished Commission. Yet, it was a research question where the conceptual framework is not that different. Government policy can have a material effect on supply and it is that conclusion with which I'd like to begin my comments.

Bob Mendenhall provided the focus of my comments and Charles Miller blessed his guidance. Although, I would hold neither responsible if I digress or fail your expectations. And I would hope that the Commission would put me back on task should my comments be of little value.

The three primary components of my comments today are:

1. The role of private capital in higher education
2. The pros and cons of for-profit higher education from an educational and societal point of view and
3. Incentives, which might encourage the commitment of private capital for educational and training purposes

**Point One: The role of private capital in higher education**

Let me begin with a brief definition. I consider the term "private" capital as one that is used primarily to distinguish it from public capital, public funds or government support.

In referring to "private" capital throughout my comments, I focus primarily on the "private" capital that has been transformed into "public equity". In other words, private investors once funded Apollo Group, which owns the University of Phoenix. The private capital is now "public" as a result of an equity event known as an IPO, or initial public offering.

There have been dozens of other equity events in higher education, many of which have transformed what we loosely call "private" capital into what is now considered "public" equity.

Again, in my comments, all references to private capital are about companies, which are now "public companies". It is my contention that those companies are valid and appropriate proxies for private capital. In addition, studying those companies enables me to speak to the three points on the agenda that I was tasked to address.

My testimony was provided to you, as was a separate document, which includes several charts and graphs to which I will refer.

As can be seen on page 1 of the attachments, private capital's role in higher education manifests within the buckets labeled "Title IV Degree Granting" and "Title IV Non-Degree Granting". That bucket has runneth over since 1991 when DeVry went public.

The market has seen the addition of roughly one equity per year since DeVry's IPO to where we now have 12 publicly traded equities within postsecondary education. And the growth in the equity value of those companies has been dramatic; today their total equity value is $27 billion. This data is displayed on page 2 of your attachments.

(The equity value of a company is calculated by multiplying the total shares of stock (equity) outstanding by the market price for each share.)

The combined equity value has ballooned because the student enrollment at the schools owned by those companies has ballooned. From DeVry's initial enrollment of 20,000 students in 1991, these companies now enroll roughly 1 million students. This equates to roughly $30k of equity value per student, which is, with some exceptions, about twice the average tuition paid by their students annually. And, it is also three times the average annual tuition paid by students in this country.

While the role of private capital has been growing, it remains a minority share. I believe its market share will grow significantly for the foreseeable future. In fact, if we extrapolate from the trends described here, by 2016, the equity value of these companies would be nearly $80 billion, their enrollment would be 1.6 million, and their market share would be almost 8%. Those trends are also shown on page 2.

## Point Two: The pros and cons of for-profit higher education from an educational and societal point of view

Again, I think it is helpful to understand my bias. I have been writing equity research on this sector since January 1997. And, in the past 9 years, I have been somewhat resolute in my recommendation to invest in the stocks. That bias has been wise for nearly all of those years, but for 1999 and 2005.

Yet, my bullishness has never suggested that I necessarily cheer for these companies. In fact, as a citizen, I harbor great concerns about these companies and their burgeoning share of this

important industry. Nevertheless, I recognize the attractiveness of the business models to investors and I have been able to insulate my equity analysis from my personal concern.

I grouped the "pros" into three categories: **scale, access and innovation.**

**SCALE**

By scale, I mean size – the number of schools, the student body.

Each company's pursuit of scale was initially funded by the capital provided by their respective, primary equity event—the IPO. These companies are not the darlings of Wall Street bankers. The companies do not usually need bankers to raise additional cash for them after the IPO has been completed. The reason being the business operations generate more than enough cash flow to enable the companies to execute a panoply of growth initiatives – each of which help the companies achieve more scale. In other words, once scale has been achieved, growth should be self-funding.

I will touch on some of the various growth initiatives briefly in the final half of my presentation, but, in summary they are: (1) acquisitions, (2) new locations or what we call Greenfield activity, (3) new programs, and (4) online campuses.

The cash flow that is generated by operations has funded the growth in the number of locations as can be seen on page 5. Obviously, these locations have been a driving force in enrollment growth, which we also saw, in a previous slide. And, as a result, the combined market share has blossomed.

**ACCESS**

Secretary Spellings tasked the Commission to address issues of Access, Affordability, Accountability and Quality. As can be seen on page 6, the number of locations has grown dramatically. And, the surge in locations has been disproportionate to areas with high percentages of minorities. For instance, the five cities in blue represent five of the top seven metropolitan areas in terms of African-American enrollment. Each of these cities has become home to more than 10 new for-profit campuses in the last ten years. Thus, it is arguable that private capital has increased accessibility for minorities.

On a broader level—irrespective of address—our data analysis, which can be seen on pages 7 and 8 of the handout, confirms that "for-profit" schools serve a higher percentage of minorities than do their peers in the traditional market. For example, the combined percentage of blacks and Hispanics at "for-profit" schools is 34% versus 22% for All-Degree Granting Institutions.

I believe Access and Affordability are deeply interwoven – for an accessible location, may not be an affordable school. And, while I believe private capital has done an admirable job of building locations and increasing accessible locations, I am less impressed by what private capital has meant for affordability.

As can be seen on page 10 of the attachment, the average price point ($15k) at the schools operated by these companies is certainly no bargain. We believe that consumers are not nearly as price-sensitive as perhaps they should be and, as a consequence, the gains in market share have not been stunted by the inexorable upward trend in price.

**INNOVATION**

The third "pro" in today's presentation is "innovation" provided by private capital or the "for-profits." It may not be fair, in all cases, to fully attribute these innovations to the "for profit" companies, as I did not take the pains that would be necessary to confirm that the attribution is completely valid. Nonetheless, I am confident that most of the innovations listed on page 11 are sufficiently unique and of sufficient scale to argue that our attribution is fair.

I split the innovations between (1) the use of Internet technologies; and (2) "other".

**Use of Internet Technologies**

We believe that the use of Internet technologies is far more pervasive within the business processes of private capital than within the traditional market. We believe student application, financial aid processing, overall communication, and placement are highly dependent on Internet technologies. Without question, the for-profits have made far more use of the Internet than their traditional brethren when it comes to student acquisition and instruction.

In fact, few industries, if any, have been as aggressive as these education companies when it comes to using the Internet in order to identify "leads" or prospective students. We estimate that the companies may spend more than $500 mm annually to acquire leads that were generated by the Internet. If time permits, we can re-visit this specific and troubling trend.

Yet, instruction via the Internet is the innovation most readily identified with the "for-profits". Online campuses have blossomed throughout the sector. Please refer to page 12 of the handout. Each of the public companies we cover offers some variant of an online campus. Certainly, the University of Phoenix is the most well known with 150,000 online students.

Furthermore, the methods of online delivery are mixed. Some of the schools have enrollment that is exclusively online while others use "online" to complement the basic classroom instruction.

**Other**

I will mention only a few of the "other" innovations. I mention these, as I believe each one has contributed to the growth of the companies and, if traditional schools would copy these techniques, I am certain that they would be better able to protect their dwindling market share.

First, I would like to mention Frequent Starts or Enrollment Periods. Education consumers, particularly non-traditional ones, are often impulsive. One such consumer may be a tired and frustrated wage earner, collapsed on a couch watching a sporting event. That wage earner's attention may be grabbed by an intriguing TV commercial that promises a fresh start and a new career. The frustrated wage earner grabs the phone, calls the 800# and, within a few days, finds himself enrolled at the University of Phoenix.

What would have happened had that student called a traditional school? In most cases, he would have been asked to fill out applications for the next academic period, which begins in perhaps several months. Imagine if you wanted to buy a television in February and the storeowner said, *"Super. We'd love to have your business. Place your order today and we'll deliver the television right after Labor Day when television season begins."*

Frequent starts give the "for profits" a significant competitive advantage over traditional schools. As you can see on page 13 of your handouts, almost every company within this group of schools starts programs nearly every month and, in some cases, more often.

Frequent starts are often enabled by another innovation, what I like to call the "wheeled" curricula. In the wheeled system, the curriculum is broken into modules that are delivered in sequence. However, under many circumstances, students can jump onto *the wheel* at any module and thereby complete the program after one full rotation of the wheel. Thus, starting periods are not limited to one module.

**Multiple Storefronts**

Frequent starts speak to the core of the operating mantra for private capital in public educationa: M*ake it convenient*. Convenience is what has driven the University of Phoenix from 0 to 300k students in thirty years. Convenience sells. Offering multiple starts is about convenience. Online learning is about convenience, although some day it may be more about learning efficacy.

And multiple locations are about convenience. I live in Marin County, just north of San Francisco. The University of Phoenix enrolls about 400 students in Novato, which is deep inside Marin County. What is the appeal of the *"University of Phoenix"* in Novato, a bedroom

community outside of San Francisco? San Francisco is home to distinguished brands such as San Francisco State, University of San Francisco, City College, Golden Gate University, and University of California. The appeal of the UOP in Novato is convenience.

Not that it was necessary, as it seems highly intuitive to me, but David Card actually conducted an extensive social experiment from which he concluded that having a college or university near one's home substantially affects one's probability of enrollment. His study was cited within Daniel Hamermesh's presentation to this Commission.

Few working adults would have the stomach to drive across the Golden Gate Bridge after work for classes. So why doesn't SF State, USF, Golden Gate or UC offer classes in Marin? I suppose it's inertia.

Much of the innovation that I have described and listed on page 11 is just common sense. But it is common *business* sense, something that may not be as pervasive at traditional schools as one would hope.

**Retention Practices**

A final example of innovation was driven by necessity, which we know is the mother of invention and perhaps innovation. Because of the time lapse between the application date and the first day of classes, all colleges are at risk of losing previously committed students. Thus, the for-profit companies work fervently to improve their "show rate," which is the percentage of enrolled students who "show" up for class. Career Education, which is now one of the more notorious companies in the group, uses something they call their "Stitch In" program. The company's enrollment advisers "stitch in" the accepted student so that his or her commitment doesn't unravel before classes begin. The extra effort may include frequent emails, occasional phone calls and possibly invitations to school events.

## Point Two (Continued): The Cons

Secretary Spelling's mandate for the Commission is to focus on accessibility, affordability, accountability, and quality. There is a growing body of evidence that the "for profits" are not, in general, enhancing the quality of education nor are they sufficiently accountable for their transgressions. The instances and allegations of fraud and malfeasance are sufficiently known to this Commission that I need not reiterate them. However, I provided a nearly comprehensive list on page 16 of the handout.

Too many of the companies continue to sacrifice the integrity of our higher education system at the altar of earnings growth. And, I suspect that those sacrificial practices will continue until the deterrents are more common, more readily enforced and more severe. The temptation is too great. The rewards are plentiful.

But what troubles me more than the transgressions is something far more insidious and ubiquitous. It's what I call the *silent sufferers:* The students who did their work, finished their programs and are left burdened by disappointment and student debt. They entered into a contract in which they thought a brighter future was a certainty were they to complete the terms of the contract—their studies.

In reality, their lot in life is no better and perhaps worse. And for this disenfranchised and silent contingent of education-consumers, we are all to blame, for we constantly tout the so-called wage premium for higher education. We plaster the media and scream from the rooftops about the wage premium -- that *in 2003, the average full-time year-round worker in the United States with a four-year college degree earned $49,900 -- 62 percent more than the $30,800 earned by the average full-time year-round worker with only a high school diploma. (College Board, Education Pays).*

I recently Googled "wage premium" and was offered 2.8 mm results in .43 seconds. I will not share each of those references, but I did attach a sampling of them on page 14 of the handout.

We have irresponsibly failed to include the following caveat emptor with the promise of the wage premium: *You are not guaranteed to earn this premium, even if you finish your studies*. In fact, we lack the evidence to even suggest that your chances are pretty good. Quite simply, we have failed to offer any empirical evidence to establish education as being causal, not merely coincidental, in relation to the security of the wage premium. Too often, degrees provide career opportunities because of the *presumption* of proficiency, not because of the evidence of proficiency.

Colleges lack the instruments needed to demonstrate that a student's investment has enhanced his or her productivity, his or her proficiency. We believe the competency-based approach at Commission Member Mendenhall's Western Governors University may be worth further review. But, it is truly an exception. There are too few examples of assessment instruments being used by schools in order to determine whether their student is obtaining the proficiency that is needed to earn the "wage premium." There is far too little transparency regarding "value added" or "value received." Instruments like that are sorely needed.

No enrollment adviser at any school of which I am aware would describe the harsh realities of the workplace. There are no disclosures regarding the turnover, the work conditions, and the harsher facts regarding whether the wage premium is relevant or attainable, let alone truthful for the job outcome to be secured by that student. Reg FD (full disclosure) may exist on Wall Street, but it is irresponsibly absent in admissions and placement offices.

The for-profits are overselling the promise of education because society is irresponsibly selling it. Thus, the for-profits are delighted beneficiaries of the intoxication of the wage-premium and, as a consequence, their attractive business models generate very compelling returns for shareholders and managers alike.

This provides me with a segue to my final point.

**Incentives, which might encourage the commitment of private capital for educational and training purposes**

I wanted to speak to this final point, which was proposed by Chairman Miller.

I do not believe that additional incentives are needed to encourage the commitment of private capital. The business is appealing enough. I recall something that Robert Silberman, the CEO of Strayer Education, said to me shortly after taking the helm of Strayer and not long after leaving his position as President and Chief Operating Officer of Cal Energy. Silberman said, *"Any smart manager would give their thumbs to run a company in this industry."* Mr. Silberman still has his thumbs and he is considered to be the best CEO in the sector.

Few businesses offer returns (as measured by Returns on Invested Capital) that can compete with this group. Please see the table on page 9 of the handouts that shows Returns on Invested Capital. The returns from this business are extraordinary, better than nearly any other sector on Wall Street. In fact, I doubt that another sector exists which offers returns of this level. When compiling the list that you see, we struggled to find a company whose returns exceeded the best that my group had to offer. With returns of that level, no incentives should be necessary.

And, furthermore, the opportunity to become a millionaire is well documented as can be seen by the perhaps stunning list of insider transactions, also in your handouts on page 15.

However, if capital from the private sector is needed to boost accessible capacity in higher education, what can be done to attract more private capital? I have two ideas and a closing point.

**(1) Stimulus to Cultivate Management**

First, I would recommend that policymakers craft a **stimulus for the cultivation of management to operate the schools**. Nearly every CEO within of the for-profit companies has, at some point, lamented the shortage of capable managers. They have stated in perhaps only slightly different terms that the most significant gating factor to faster growth is the absence of management capacity. With returns on invested capital that easily exceed the cost of that capital, any wise manager should choose to deploy more capital as quickly as possible—but not without stewardship. Who would run the schools if they were to accelerate their rate of openings?

Thus, what stimulus could government provide that would generate more management capacity? I cannot propose a sweeping policy that would address the problem of inadequate management capacity. But I offered a small idea or initiative to Robert Silberman of Strayer a few years ago. I recommended that his schools offer an MBA with an emphasis on management of for-profit post-secondary education institutions. Thus, he could turn a problem into a profit-center that would generate his own managers. I have no idea as to what happened to my idea.

Traditional education programs do not cultivate enough business-savvy leadership that is needed to run higher education institutions in this increasingly competitive landscape.

**(2) Fast-track licensure and accreditation**

Higher education needs to become more responsive to the needs and demands of employers and students, especially involving non-traditional students. If skilled labor is needed, initiative should not be met with obstruction. The DOE should fast-track licensure and accreditation in order for responsive educators to begin generating skilled labor for where it is needed.

I encourage the Commission to read "Forging Tomorrow's Artisans" in the Chronicle of Higher Education (January 6, 2006). The story describes the American College of the Building Arts. The School is generating output (skilled tradespeople) to address a workplace need that is now being addressed by importing artisans from Europe. What other jobs are being filled by imports because of the shortcomings of our education capacity?

Yet, until the American College of the Building Arts earns accreditation, its students are not eligible for federal student-aid programs. And, furthermore, most accrediting agencies are ill equipped to evaluate the unique program.

**FINAL POINT**

I would like to close by re-orienting Chairman Miller's question. Instead of asking what incentives are needed to attract more capital, ask: *"what incentives are necessary in order to better align societal objectives with investor objectives?"*

My former advisor at Stanford, Michael Kirst, has written extensively about the misalignment between the K-12 years and the college years in his report entitled "Betraying the College Dream: How Disconnected K-12 and Postsecondary Education Systems Undermine Student Aspirations."

According to Kirst, states have created unnecessary barriers between high school and college, barriers that are undermining student aspirations. The current fractured systems send students, their parents, and educators conflicting messages about what students need to know and be able to do to enter and succeed in college. For example, his research found that high school assessments often stress different knowledge and skills than do college entrance and placement requirements. Similarly, the coursework between high school and college is not connected; students graduate from high school under one set of standards and, three months later, are required to meet a whole new set of standards in college.

I believe Kirst and his associates should write the sequel—Betraying the College Dream: How Disconnected Postsecondary Education Systems and the Workplace Undermine Student Aspirations, the U.S. economy and Investors.

I believe Kirst would find that schools have obfuscated the connection between college and the workplace, thereby undermining student aspirations. The current system sends students conflicting messages or hyperbole about what students need to know in order to succeed in the workplace and secure that wage premium. I think his research would find that college exams stress different knowledge and skills than are required by our economy. I think his research would find that the coursework in college is not connected; and that students graduate from college under one set of standards and, three months later, are required to meet a whole new set of standards in the workplace.

Kirst laments the resources spent in colleges remediating high school graduates so that they can begin taking courses for credit. How about lamenting the resources spent in corporate America remediating college graduates so that they can begin working productively?

The prescription for change or a remedy already exists in private capital as a core component to the business model of Universal Technical Institute. UTI is aligned with the workplace because the company solicits the input of the workplace. UTI partners with original equipment

manufacturers, suppliers and employers to ensure its students are trained specifically to meet the industry's needs.

UTI’s approach creates a high level of involvement from key industry participants and produces well-trained graduates who are valued and in demand. Participating companies support UTI's educational model by sharing proprietary curriculum and training methodologies and donating equipment, including vehicles, diagnostic equipment and specialty tools. The participating companies serve on advisory boards to provide feedback on course content as well as graduates' performance in the workplace. In addition, many of the company's employers participate in UTI’s Tuition Reimbursement Program, whereby a company pays the graduate's educational loan payments while the graduate is an employee.

The Tuition Reimbursement Program has been a good recruitment and retention tool for UTI's employers and a nice benefit for the students. In addition, the program actually benefits UTI by helping lower student loan default rates. Furthermore, the top 20% of UTI's automotive graduates have the opportunity to take manufacturer-specific training with companies such as Audi, BMW, Mercedes-Benz and Volvo. This additional training, which is 3-6 months in length, is free to the student. The manufacturer pays UTI to train the students in exchange for the students' commitment to go to work for one of the manufacturer's dealers. Students who participate in a manufacturer specific training program typically earn a premium of $3-$6 an hour as compared to a graduate with no manufacturer training.

If this all sounds eerily reminiscent of apprenticeships, Chaucer and Canterbury Tales, then it must be. Absent the draconian working conditions and child labor, of course.

I wish to conclude my comments at this time.

Thank you for your interest in my insight on this compelling subject. The opportunity was a great honor for me.

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| Volatility | | Ratings | | |
|---|---|---|---|---|
| | | **Buy** | **Neutral** | **Sell** |
| Low | 0%-25% | 8%+ | 7.9%-(4.9)% | (5)% or worse |
| Medium | 25%-35% | 11%+ | 10.9%-(6.9)% | (7)% or worse |
| High | 35%-55% | 15%+ | 14.9%-(10.9)% | (11)% or worse |
| Extreme | 55%+ | 30%+ | 29.9%-(19.9)% | (20)% or worse |

Source for volatility: Bloomberg.

### Rating Distribution*

**Global Coverage**

| Coverage Universe | Companies | Pct. | Investment Banking Clients | Companies | Pct.** |
|---|---|---|---|---|---|
| Buy | 381 | 40 | Buy | 289 | 76 |
| Hold | 512 | 54 | Hold | 408 | 80 |
| Sell | 49 | 5 | Sell | 36 | 73 |

**Business Services Sector**

| Coverage Universe | Companies | Pct. | Investment Banking Clients | Companies | Pct.** |
|---|---|---|---|---|---|
| Buy | 7 | 50 | Buy | 2 | 29 |
| Hold | 6 | 43 | Hold | 4 | 67 |
| Sell | 1 | 7 | Sell | 1 | 100 |

* For the purposes of this Rating Distribution, “Hold” is equivalent to our “Neutral” rating.
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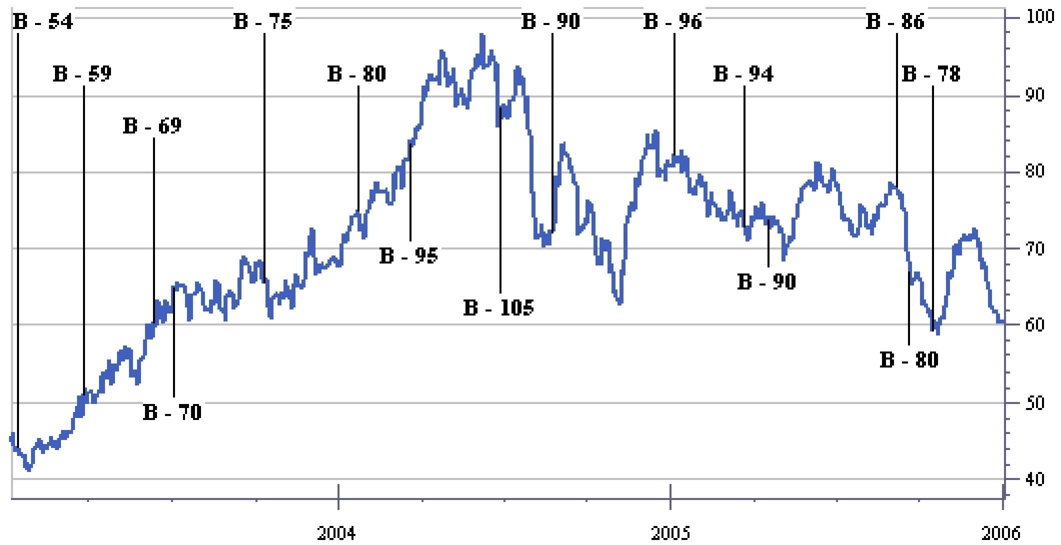
**Apollo Group, Inc. (APOL)**

**Target Price, Valuation Method, Risk Factors**

| | |
|---|---|
| **Target Price:** | $68.00 |
| **Valuation Method Used To Reach Target Price:** | Our $68 target price implies a forward free cash flow multiple that is a discount to secular EPS growth, balancing superior ROIC (78%) against decelerating growth and recent changes in management. |

**Risk Factors:**

1. Risks associated with the new focus of enrolling lower caliber students in lower credit programs.
2. Risks associated with the uncertainty of the online market which is becoming of increasing importance to overall growth.
3. Risks associated with regulation and other rules that influence operations.
4. Risks associated with new locations, particularly those in new markets.



Apollo Group Inc. (APOL)
Stock Price Chart (rating and target price changes indicated)
U.S. Dollar (Jan 2, 2003 - Dec 30, 2005)
Current Analyst: Block H.
Rating System as of Jan. 12, 2003
New rating system: Buy, Neutral and Sell
Prior rating system: SB, B, MP, U and S
B - 54
B - 59
B - 69
B - 70
B - 75
B - 80
B - 95
B - 105
B - 90
B - 96
B - 94
B - 90
B - 86
B - 78
B - 80
100
90
80
70
60
50
40
2004
2005
2006
SB=Strong Buy, B=Buy, N=Neutral, MP=Market Performer, U=Underperform, S=Sell, CIT=Coverage in Transition
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