

MEMORANDUM

To **Secretary of Education's Commission on the Future of Higher Education**

From Trace A. Urdan, Senior Research Analyst, Robert W. Baird & Co., Inc.

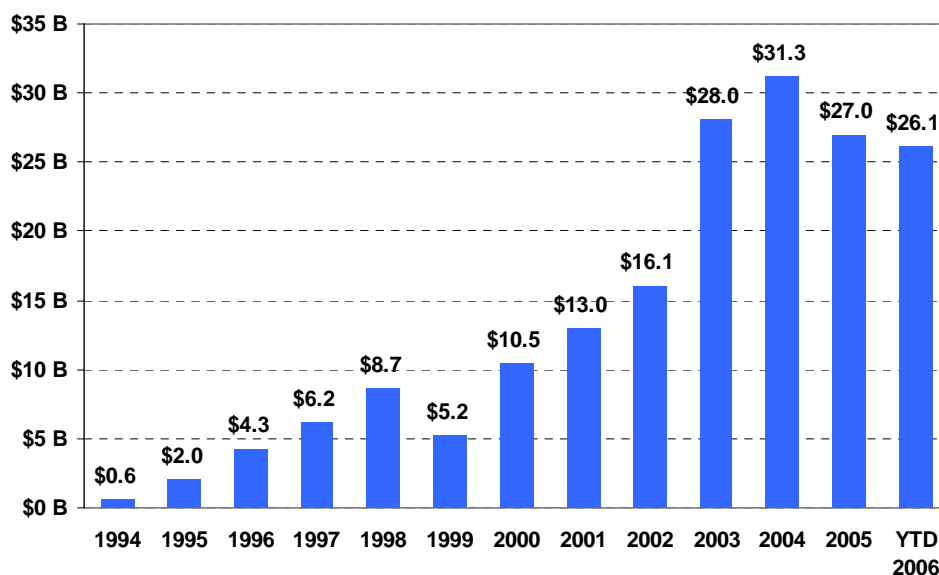
Subject The role of private capital in higher education

Date Thursday, February 2, 2006

Note Please refer to Important Disclosures and Analyst Certification on page 9.

Since 1994 when Apollo Group (NASDAQ: APOL) joined DeVry Inc. (NYSE: DV) as the second, publicly-traded, for-profit, degree-granting university, public equity investment in the sector has grown at a compounded rate of 37% to total more than \$26 billion today, and the list of public companies now totals 12. In fact, one dollar invested in Apollo's 1994 IPO today is worth more than \$71; and there are few, if any, large mutual funds that do not have some exposure to this sector. At the same time, private equity investors, including some of the largest and best-respected firms in the financial services industry, have invested additional billions in grooming prospective acquisitions for the public companies and/or new IPO candidates.

Exhibit 1: Market Capitalization of Public For-Profit Post-Secondary Companies



Source: FactSet Research Systems, Robert W. Baird & Co., Inc.

The phenomenal success of the proprietary college market as an investible sector over a period of years is a result of the group's nearly perfect complement of attributes highly-prized by growth investors. These include four Ps, namely market size and **potential** for future growth, a unique or otherwise differentiated **product**, a recurring or **predictable** stream of revenue, and a leveragable **profit** model in which margins expand as the enterprise grows. Over the past two years, increased regulatory scrutiny, as well as some deceleration in the pace of enrollment growth experienced by the leading players, has dampened investor enthusiasm, resulting in a contraction in the average share price. However the strength of the business model, in particular its ability to convert a high percentage of earnings into free cash flow, remains undisputed and investor interest remains healthy even if more muted than the highs of 2004.

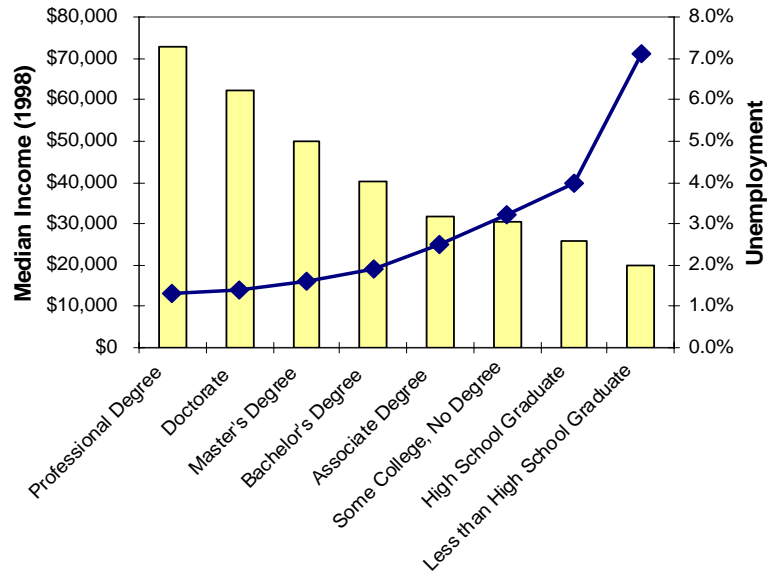
Potential

Knowledge has become an increasingly important driver of the U.S. economy. Over the past four decades, economic and technological forces have transformed the economy from one in which corporate value was understood primarily as a function of physical and financial assets, to one that places a growing premium on intellectual capital. Today, skilled jobs comprise 65% of all employment, a dramatic increase from 20% in 1950.

Demand for educated workers has outstripped the supply. Workers are faced with more complex challenges, requiring higher levels of education, computer literacy, critical thinking, information analysis, and synthesizing skills. In the midst of globalization and technological revolution, lifelong learning has gone from being a luxury to a necessity for employers and employees alike. As this shift in the economy has taken place, employers' requirements have increased, resulting in a salary premium for education: the pay gap between males who have a college education and those who only hold a high school diploma has widened in the last decade alone from 45% in 1980 to an estimated 65%+ today.

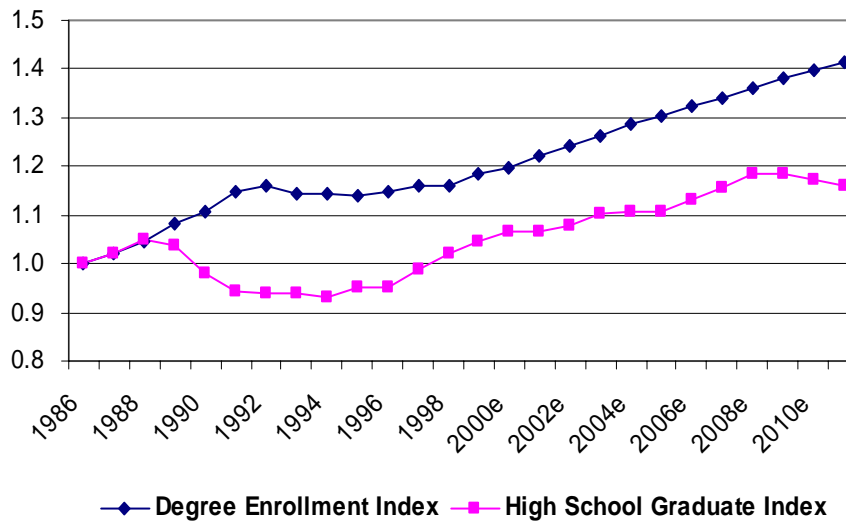
Not surprisingly, as a result, participation rates in post-secondary education have increased. Growth in college attendance has outpaced the general growth of the population of 18-22 year-olds, suggesting that a greater percentage of the population is going to college. In 1995, 65% of high school graduates enrolled in a post-secondary institution, up from 49% in 1980. In addition, a large number of adults are returning to college in some capacity after their teenage years. Today, adults aged 25 and over represent 43% of all post-secondary enrollments, up from 28% in 1970.

EXHIBIT 2: Average Income for Various Levels of Educational Attainment



Source: U.S. Department of Labor

EXHIBIT 3: Index of Post-Secondary Degree Enrollment Growth vs. High School Graduation Rates (1986-2011)



Source: U.S. Department of Education, Robert W. Baird & Co., Inc.

A small paradigm shift in a large market can create enormous opportunity. The broadly defined education market encompasses pre-K education through adult vocational and corporate training and represents more than \$900 billion in annual spending. It is second only to healthcare in terms of its role and importance in the U.S. economy. Post-secondary education makes up roughly one-third of this total. The federal government conservatively projects that enrollments in higher education will reach 16 million by 2008, up from approximately 15 million today. Our view is that the changes described above present a significant opportunity for value creation in such a large and dynamic market.

The growing demand for higher education among a non-traditional student population represents one such paradigm shift that has contributed to the rapid rise of proprietary institutions. For-profit growth should continue to be fueled by growth in the traditional 18-22 year-old student population through 2009, further expansion of the market through greater participation by adults (only 21% of American adults over the age of 25 have a bachelor's degree or better), and by continued share gains from less responsive, and/or resource-constrained public and not-for-profit institutions.

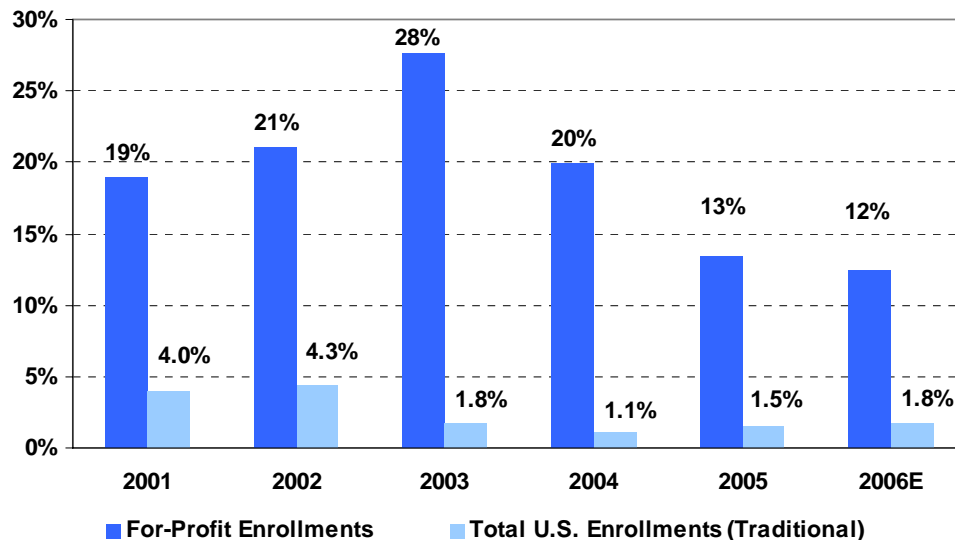
Product

Broader participation in the higher education market combined with rapidly rising costs has resulted in a more discriminating consumer with a new psychographic profile. Both high school graduates, who might have alternatively pursued a craft or blue collar vocation, and adults going back to school are approaching the college experience with a very practical cost-benefit orientation. They want to acquire skills that are going to be immediately relevant in the workplace and are increasingly pragmatic and demanding of their educational experience. While brand image remains extremely important in the purchase decision, it matters only so much as it carries weight with potential employers.

Consumer influence has grown as well during this period, as the Web has empowered buyers through improved access to information and more flexible delivery options. Traditional regional monopolies held by state and community colleges have been disrupted not only by Internet-delivered programs but by the greater ease with which students may learn about and apply to competing colleges. Finally, the rise in various certifications and standardized tests has resulted in greater accountability for the quality of various degrees, holding degree-granting institutions accountable to corporate employers for the first time.

The rise and significance of this new consumer attitude has been missed by the traditional educational establishment. Historically, colleges and universities were immune from outside forces: they enjoyed regional monopolies, as accreditation, state, and federal approvals created high barriers to entry. Consumers were fragmented, with little buying power, as their tuition revenue was often incidental to the operating budgets of large institutions. As a result, academic institutions had no real accountability to stakeholders. In addition, the paternalistic culture of most traditional educational institutions places students at the bottom of an elaborate hierarchy in which expert professors, rather than consumers or prospective employers, determine curriculum. Beyond this, state subsidies, inefficient governance, and a general attitude of self-importance have left state and community colleges open to the rise of for-profit competition. The growth of for-profit competitors, far faster than the overall market, points to the remarkable share shift that has taken place. Even today as advocates for publicly-funded institutions lobby for greater subsidies, their rhetoric ignores completely the growing role of proprietary schools in addressing unmet needs.

EXHIBIT 4: For-Profit Enrollment Growth vs. Total Market



Source: Department of Education, company reports, and Robert W. Baird & Co.

For-profit education has become a permanent part of the education landscape. The high-quality operators in the space have been responsive to this new consumer demand, adapting curricula to suit both student desires and the requirements of prospective employers; developing programs in areas like

information technology, allied health, and education, where major demand for skilled graduates outstrips supply; responding to the needs of working adults with innovative scheduling options, liberal recognition of prior college attendance, and online education; and working diligently to ensure that students stay in school and secure attractive employment opportunities after graduation. While it is not impossible for the traditional public and not-for-profit educational establishment to become more competitive over time, anecdotal evidence suggests the institutional barriers to change remain high.

The for-profit players face extra regulation designed to ensure that product quality remains high and appropriate to the public investment represented by state and federal aid and loan programs. Unfortunately, however, it has also contributed to a culture at some for-profit companies to operate as aggressively as possible within the strictly legal scope of the requirements, rather than being ruled by customer requirements. As a result, both regulators and the press have rightly accused some institutions of losing sight of the fundamental value proposition offered by their programs. While mediocre program quality may be tolerated by students at state-subsidized community colleges where prices and expectations are low, many proprietary schools have learned hard lessons over the past two years about elasticity of demand. That said, we expect regulatory pressures to ease over the coming year as fines are levied, abuses are checked, and student growth continues.

Predictability

In general, the secular trends governing demand for the proprietary sector remain relatively stable and predictable, as does the basic momentum behind the growth of individual brands. Because revenue is a function of enrollment, and enrollment is typically a 2–4 year decision, providers can generally budget their costs quite accurately. Furthermore, new student enrollment can be projected with a fair degree of accuracy based on capacity, seasonal patterns, advertising spending levels, and, of course, lead flow. An orderly pace of new campus openings in new markets contributes to the predictability of growth as well.

However over the past two years, regulatory actions and an improving economic cycle have tested some investor assumptions about secular demand. For while revenue performance remains predictable given known truths regarding student population and tuition levels, enrollment trends have proven more volatile than investors (or most analysts!) had really understood. That said, unit volume and pricing growth in this sector remain superior to most other cyclical consumer-based businesses and many

corporate services businesses as well aided in large part by the federal programs that subsidize student expenses and remove some dependence on the economic cycle that characterizes most other consumer businesses.

Profitability

Proprietary schools, because they focus on high-demand career training and areas of peak interest, such as video game design and accounting and can quickly fold programs that are not proving attractive, operate far more profitably than traditional institutions where such decisions can often take years and involve multiple stakeholders in an effort to reach consensus. Proprietary schools are not burdened by having to subsidize intellectually valid, but wildly unpopular programs or compensate unproductive but tenured faculty.

Most proprietary schools operate from a standardized curriculum that allows for a consistent and more responsive instructional product as changes can be made definitively system-wide. It also allows for a greater reliance on part-time and practitioner faculty which, though often cited as a negative by accreditors, are generally favored by students, even in instances when they may be critical of other aspects of a program. Both practices contribute to efficient scheduling and year-round frequent starts and whether the class is being offered online and on-ground, contribute to more efficient capacity utilization, which in turn drives margins.

Because tuition revenue is generally collected in advance of the semester, particularly the portion that comes as the result of a government subsidy or sponsored loan, working capital requirements for proprietary schools are minimal. In addition, low capital expenditures resulting from minimal extra-classroom campus amenities contribute to a strong return on invested capital.

Finally, proprietary schools are operated as reasonably efficient businesses, where every marketing dollar can be evaluated in terms of lead flow and enrollment and very little is spent on image-oriented advertising or on attractive but inefficient brochures. In fact, every expense can be looked at on an ROI-basis and multi-million dollar cost overruns for expensive software installations are simply not an issue.

Recommendations

Encourage state lawmakers to really articulate what taxpayer support of higher education is meant to accomplish and then take a hard look at the existing, often baroque, network of two- and four-year offerings, tune out stakeholder complaints, and assign funds where they will best further those goals and require other institutions to survive in the market on their own merits. For states with shrinking populations to subsidize state institutions so they can actively market to students from other states may be a strategy to support a football program, but it disserves the taxpayers footing the bill.

Encourage state lawmakers to allow institutions to privatize while directing greater resources to individual aid. State colleges and universities, particularly community college systems amount to state-run enterprises and suffer from all of the inefficiency and poor decision-making of Soviet-style factories. A community college, true to its mission and focused on the pragmatic, ought to be able to put proprietary schools out of business by virtue of the subsidies it receives. The fact that this has not happened suggests a problem with governance. Though the process of relying more on student tuition and rationalizing costs is painful for state schools, it is healthy. Placing state funds in the hands of students as need requires and making them pay what the education actually costs to produce empowers students to support effective institutions and allow redundant institutions to wither.

Rationalize federal (and where possible state) change of control laws. What regulators view as investor "speculation" can actually represent a healthy and necessary injection of capital, sensible management and industry consolidation. Yet the rules throw up multiple hurdles and roadblocks to private equity participation. They likewise discourage what could actually be a healthy consolidation of brands. Maintaining a network of family-owned schools operated as cash cows serves no quality or public policy goal, but is the effect of the formal discouraging of professional investors in the sector.

Update financial viability rules to allow for the realities of the marketplace. Well-run institutions can generally support higher levels of leverage than the current rules allow. Better-informed rulemaking and administration in this area could have a significant impact on the ability of private capital to invest in the sector.

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