footnoted*pro
reading filings so you don't have to

May 17, 2010

A lesson in risk, from for-profit education companies

Big changes are afoot in the for-profit education sector, with new regulations in the works from the U.S. Department of Education that could crimp the profits of a number of companies. The impact won't be uniform across the industry, and -- so far, at least -- neither is the level of disclosure that companies are providing. Below, we take a quick look at how much detail some for-profit education companies are providing (or failing to provide) about the potential risks.

The new rules will determine which programs at which companies will qualify students for financial aid under the government's Title IV programs. It matters because these programs typically contribute as much as 80% of revenue at these companies, and often more. The regulations are growing out of increasing concern over students who leave with big debt loads and poor prospects for earning enough to repay it in reasonable time. Federal officials say they're reluctant to devote federal aid to educational programs that over-promise, under-deliver and leave graduates swamped with debt. The regulations are due in final form this fall, to kick in mid-2011, and after several weeks of negotiated rule-making early this year, the government's proposals are shaping up to include a mix of new academic standards, limits on the incentives that companies pay to recruiters and financial-aid advisers, and formulas to gauge how employable and how well paid graduates are relative to debt levels. The for-profit education industry has been working hard to head off or mitigate the rules that do come out, arguing that they will "displace" hundreds of thousands of students and slash participation in for-profit education. (Inside Higher Ed has a thorough primer on one of the key issues; Frontline, on PBS, recently undertook its own look at the industry.)

Depending whose filings you read, you might not get a good sense of the magnitude of the impending changes. Some companies have updated their risk factors, keeping pace with the negotiations. Others haven't, including **DeVry Inc.** (DV), owner of DeVry University and a range of schools for everything from nursing to accounting and criminal justice. DeVry's recent filings don't mention the new rules: not in the 10-Q it filed on May 6, the 8-K and press release it filed on April 22 to announce its fiscal 2010 third-quarter results, or the 10-Q it filed on Feb. 4.

Lincoln Educational Services Corp. (LINC) includes the barest of hints in the 10-Q it filed on May 7, referring to the "substantial portion" of revenue derived from federal Title IV financial-aid programs -- 81% in its last fiscal year -- and the fact that "any legislative or regulatory action that significantly reduces the funding available under Title IV programs or the ability of our students or schools to participate in Title IV programs could have a material effect on our ability

*** Click here to receive an exclusive 15% discount to Footnoted Pro ***

to realize our receivables." The company does refer back to its 10-K, where it includes two dense, essentially identical 500-word paragraphs describing the rule-making process so far, but little in the way of actual guidance on how the government's proto-proposals, as they stood at the time, might affect the company. This is about as close as it got:

> "The implementation of any of these regulatory changes, or other changes the DOE might propose and implement, could have a materially adverse effect on our business and results of operations. However, the proposals presented to the negotiated rulemaking committee are not final regulations, nor do they necessarily represent the final position of the DOE on these subjects, and remain subject to further review and change during the subsequent rulemaking process. The negotiated rulemaking committee did not reach consensus on all of the proposed regulations, which means that DOE may publish proposed regulations which differ from those presented to the committee."

Similarly, **Bridgepoint Education Inc.** (BPI), in its 10-Q filing on May 3, notes that the rulemaking and negotiations are ongoing, but provides little insight into its potential impact on the company; its 10-K, filed March 2, says the rules "could affect the manner in which we conduct our business by, for example, requiring us to change the manner in which we compensate our enrollment advisors or change the structure of our online programs. The rules also could ... require us to take additional steps to maintain our compliance with those requirements by, for example, obtaining additional approvals in the states in which we are physically located or changing the tuition or other aspects of our educational programs."
The **Washington Post** (WPO), too, is vague in the analysis in its May 11 10-Q filing: "The changes ultimately made to the Title IV regulations could adversely affect, among other things, Kaplan's ability to retain admissions and financial aid advisors and the ability of Kaplan Higher Education division's programs and students to qualify for Title IV financial assistance, and could otherwise have a material adverse effect on Kaplan's operating results."

By contrast, **Education Management Corp** (EDMC) goes further in its 10-Q on May 12, laying out some of the potential trouble spots it sees, in a chunky, 653-word section. Among them:

> "The implementation of a definition of 'gainful employment' tied to anticipated student debt and income for the purpose of determining whether certain educational programs ... prepare students for gainful employment in a recognized occupation and, in turn, whether that program qualifies as a Title IV eligible program, may affect our ability to provide Title IV funds to students enrolled in some of our educational programs or require us to decrease the tuition charged at our schools. ... The implementation of regulations which limit the ability of an institution to rely on the authorization of a state licensing agency to establish its eligibility to participate in the Title IV programs if the state agency does not meet or bring itself into compliance with prescribed standards and requirements could prevent our schools in that state from remaining eligible for Title IV funds..."

(EDMC also notes that it faces allegations of failing to meet existing recruiter-incentive rules, in a *qui tam*, or whistleblower, lawsuit filed against it by a former employee in Pennsylvania in 2007, first disclosed on May 7; the U.S. Department of Justice has declined to join in the suit, and EDMC says it "believes the claims to be without merit and intends to defend this action vigorously.")

National American University Holdings Inc. (NAUH) may offer the most insight into its likely fortunes -- and to some degree, those of its competitors as well -- under the Education Department's early proposals, with extensive disclosures in the amended S-1 it filed on May 11. And the company goes beyond broad language about the agency's efforts to far, offering at least a little perspective on the impact the government's approach may have in specific areas. (The company also relies somewhat less on Title IV financial aid for its revenue than many of its competitors do, at 71.6% last year.)

NAUH warns that the government's interest in establishing a definition for "gainful employment" -- determining pay that graduates should earn, relative to their graduating debt levels -- is the proposal "that could most significantly affect our business." Specifically,

> "If a regulation regarding gainful employment is adopted in the form presented by the Department of Education during the negotiated rulemaking ... it may significantly reduce our enrollment and have a material adverse effect on our business, financial condition and results of operations."

The government has suggested that loan payments of 8% of annual income would make a good maximum threshold, based on median debt levels for a given course of study and 10-year amortization at prevailing student-loan interest rates, among other parameters, NAUH says. "If this regulation is adopted in a form similar to that proposed by the Department of Education during the negotiated rulemaking process, it could render a significant number of our programs, and many programs offered by other proprietary educational institutions, ineligible for Title IV funding," the company adds.

NAUH also details the threat from other elements of the proto-proposals broached by the government in this winter's talks. Currently, it notes, when an institution's state doesn't require licensing -- as is true in NAUH's home-state of South Dakota for accredited private universities and colleges -- the U.S. Education Department has historically considered it to have met a federal requirements for state licensing. But during its negotiations with the industry this winter,

> "the Department of Education proposed to require that an institution possess, as condition of eligibility for Title IV programs, specific authorization from an appropriate state government agency or state entity to operate post-secondary educational programs in the state. ... If the Department of Education were to adopt regulations regarding state authorization and our main campus in South Dakota is unable to comply with such new

*** Save $1500 off a year's subscription by clicking here ***

> regulations, we would lose our eligibility to participate in Title IV programs not only in South Dakota but at all locations we operate."

Granted, with no firm federal proposals yet, it's difficult for the companies to know just how they'll be affected, something every company emphasized (if they mentioned the rulemaking process at all). But the range of disclosures suggests that some companies could do more to put the potential sweep of the looming rules in context. And given how seriously some of the firms are taking the prospect of the new regulations, failing to do so may be a real disservice for their investors.

FootnotedPro is a subscription-based product. For information about your subscription, please contact us at pro@footnoted.org.

Legal Disclosure: Morningstar, Inc. is a publisher of research and analysis about publicly traded companies. Its reports are prepared for informational purposes only. Morningstar is not an investment adviser and does not provide investment advice to the subscribers or readers of its reports. Nothing in this report is intended to be or should be understood as recommending or soliciting the purchase or sale of any security or recommending any trading strategy.

The information contained in this report is believed to be reliable and current when published. Morningstar collects information from numerous sources, but primarily relies on publicly disclosed information in SEC filings. Morningstar makes no guarantee or warranty that the information is accurate or complete.

Unless you have purchased a group subscription, FootnotedPro is sold on a single-use basis. Copying, distributing or forwarding this document in any manner is strictly prohibited, and your subscription will be canceled without a refund upon the first violation.