



Skool Daze

The next big short could be for-profit education, says SunGard's Andrew Shinn

MARKET PERSPECTIVE

The law of unintended consequences, popularised by sociologist Robert Merton in 1936, states that the actions of people—and especially of government—sometimes have unanticipated effects. This concept has been used to describe everything from the Prohibition Amendment in the US to laws mandating the use of bicycle helmets. It is also a model that helps one better understand much of what happens in business and finance.

There are many examples of the law of unintended consequences over the history of the financial services industry. For instance, Michael Milken single-handedly created the junk bond market and provided financing to higher-risk companies that never would have been able to issue bonds without him. Companies that did not have the business model to support high interest payments were nevertheless issuing millions of dollars in bonds. Many of these companies eventually collapsed under

the weight of their bonds and both companies and investors lost.

Angelo Mozilo, former head of Countrywide, said that he felt it was his moral obligation to provide mortgage financing to minorities and low-income Americans so that they could own their own home. Mozilo may have believed that he was doing the right thing by finding new ways to structure loans for people who never before could have owned a home. However, the mortgage loans that he made to many low-income people were unsustainable. When adjustable interest rates reset, many new homeowners could not afford their mortgage payments and were evicted.

Similar things are happening today in the for-profit education industry and it may present short sellers with opportunities.

It's been an interesting few years in the industry

as the Department of Education has been investigating whether for-profit education companies are taking advantage of their own students by saddling them with as much government-backed debt as possible and then not enabling them to secure jobs. As a result, many students are unable to pay off their loans. To better understand the current situation, one must go back to 1965 when President Johnson enacted the Higher Education Act. The new law was part of the President's Great Society programme to eliminate poverty, and Title IV of the Act stipulated that the US government would provide students with government-backed financing to enable them to attend college.

Most would agree that enabling students to take out a loan for college is a good thing. The problem is that the incentives stop at enrollment and do not mandate effective teaching or hiring rates. Education companies recognise billions in revenue from government-backed loans

when students take classes, but it matters less whether students can pay off the debt. The Department of Education has tried to align companies' incentives with students' ability to pay back debt by withholding Title IV payments if a significant percentage of a school's graduates are in default. Unfortunately, the Department of Education's new legislation, announced in early June 2011, has not helped to avoid these unintended consequences.

When government is involved, incentives frequently become misaligned. As Donald Rumsfeld explained, "when people spend their own money on themselves, they are careful about how much they spend and about what they spend it on. If people spend their own money on others, they are careful about how much they spend, but not as careful about what they spend it on. If people spend other people's money on themselves, they are not careful about how much they spend, but they are careful about what they spend it on. If people spend other people's money on other people, they are not careful about the amount of money they spend, nor are they careful about what they spend it on. That is government."

Technically, students are paying the cost of going to college. However, because the loans are backed by taxpayers, it's actually officials in the Department of Education who are guaranteeing loans with taxpayers' money to help prospective students. It's a classic case of government (as defined by Rumsfeld).

Furthermore, students are not really spending their own money when signing up for classes. Just as consumers spend less on average when paying for purchases with cash rather than a credit card, keeping student loans in the abstract helps encourage students to spend more than they otherwise would. If student loans were delivered in suitcases of cash and laid out on a kitchen table, students would likely be more prudent when signing up for classes.

The ultimate beneficiary are schools, both non-profit and for-profit. Indeed, many for-profit education companies are taking advantage, just as mortgage companies took advantage

of the opportunity to make questionable loans and offload them to investment banks' securitisation departments.

In an argument almost identical to Mozilo's, for-profit education companies make the case that they have a moral obligation to ensure that every American has the opportunity to go to college. But just as Mozilo did a disservice to his low-income mortgage customers who were later evicted, so too are for-profit education companies doing a disservice to students who are unable to pay back their student loans.

The problem in shorting the most troubled for-profit education companies is in the timing

In another similarity, Milken and Mozilo were consumed by the desire to increase market share, and they did whatever was necessary to grow. Some for-profit education companies also go to any length to enroll additional students and meet growth targets, even it means lying to prospective students. According to Education Management Corporation's 2010 annual report, the Government Accountability Office recently "conducted undercover investigations into the enrollment and recruiting practices at fifteen for-profit institutions of higher education...and all fifteen of the for-profit institutions made deceptive statements to the investigators." One of the institutions that made deceptive statements was Education Management.

Another concern is that the default rate on student loans is much higher than anyone wants to admit. For instance, Education Management Corporation recently sold its Education Finance Loan portfolio, but when it did so, it acknowledged that it had reserved funds to cover losses of 50 per cent of the portfolio. Students take out many different government-backed and private loans to pay for school, but when they default they don't just default on the private loans. So

if Education Management Corporation was planning for a 50 per cent default rate, the US government-backed loan portfolio should have equal reserves.

There is nothing inherently wrong with the for-profit education model. For-profit educators compete against taxpayer-subsidised state and private universities. As technology enables students to learn at their own pace, teachers may become more like coaches or guides. The move to online courses is one outcome of that trend, and many for-profit education companies are leading the way in online education.

The problem remains the incentive system set up by the Department of Education and Title IV government-backed loans. Now that the problem has been identified, it's a question of whether student debt will reach an unsustainable level, and what the catalyst will be to force the Department of Education to change regulations enough to affect the viability of select for-profit education companies.

Short sellers are active in this market. The problem in shorting the most troubled for-profit education companies is in the timing. Even if an investor realised in 2006 that the subprime bubble was unsustainable, it would not have done him much good to short at that time.

Right now, short sellers are targeting Education Management Corporation (NASDAQ:EDMC). The cost-to-borrow shares of EDMC is 3,600 basis points. Bridgepoint Education (NYSE:BPI) is another popular short. This may have to do with the strong share price performance for both EDMC and BPI over the past couple months, as the Department of Education's regulations were less severe than many had feared. A popular short trade in the past year was Corinthian Colleges (NASDAQ:COCO). The company has lost 77 per cent of its market value since April 2010 and while short interest has remained at roughly the same level for the past year at 24 million shares short, borrowing costs have declined recently. It's possible that new value investors have purchased shares at depressed levels and are more willing to lend to augment their return. **SLT**

	<u>Ticker</u>	<u>Shares borrowed</u>	<u>Intrinsic rate (%)</u>
EDUCATION MGMT CORP	EDMC	2,731,101	36.19
BRIDGEPOINT ED INC	BPI	6,831,961	8.20
CORINTHIAN COLLEGES INC	COCO	20,675,525	2.50
STRAYER ED INC	STRA	1,830,794	1.40
PRINCETON REVIEW INC	REVV	1,309,300	0.69
WASHINGTON POST CO	WPO	736,149	0.46
CAPELLA EDUCATION COMPANY	CPLA	1,047,300	0.21
ITT EDUCATIONAL SERVICES INC	ESI	5,439,142	0.21
LINCOLN EDL SVCS CORP	LINC	592,533	0.10
NATIONAL AMERN UNIV HLDGS IN	NAUH	111,700	0.10

Top ten most expensive-to-borrow for-profit education companies as of June 28, 2011.



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