

ALTERNATIVE RESEARCH SERVICES, INC.

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ITT Education (ESI) -- \$114.02

Sell Short:

Reporting 4/22 before open

Recommend Partial Short into the EPS

Risk to short: New campus growth

New Lawsuit File 4/15 Alleging Fraud Probably Unknown to Investors¹

Market Cap.	\$3.9 bil
Shares Out.	34 mil
Short Interest	3.9 mil
Days short	6.16
Avg. Daily Vol.	645k mil
St. eps est. 2010cy	\$10.38
St. eps est. 2011cy	\$11.63
Px/book	25x
Px/sales	3.23x
Px/ EBITDA	7.3x

Source: Bloomberg

Halassa page 3: “Halassa observed ITT staff alter and destroy files required to be maintained by state and federal law to maintain ITT’s status as an accredited institution and ability to participate in federally subsidized student aid programs.”

“...quickly touching on grants and scholarships. Pell Grants, we've seen increases there over the couple of years, not only in the amounts, but also in the eligibility percentages because of some changes in the calculation criteria. So that's been a very positive thing for us, increased levels of Pell Grants for our students. And that probably hasn't completely played itself out, so you'll likely see some incremental increases there versus the numbers we disclosed in our 10-K that we just filed.” --Mgmt conference 2/22/10

“Teachers at ITT Tech must reach a quota of student attendance AND pass a certain number of students in each class to keep teaching the class.”²

- ESI is expected to report earnings prior to the open on April 22nd. With an earnings estimate of \$2.28 for the quarter vs. \$1.59 in the year ago period, we believe that ESI shares remain vulnerable in 2010. By quarter in 2010, yoy growth is expected to be: 44%, 37%, 28%, and 18% for an average of 31%, down from 51% in 2009. 2011 EPS growth is expected to slow further to 12%. Despite a 2011 estimate of \$11.63, we believe ESI shares are increasingly vulnerable to slowing. In 2009, operating margin

¹ Halasa vs. ITT Educational Service Southern District of Indiana 1:10-cv-0437WTL-JMS (attached)

² <http://www.ripoffreport.com/adult-career-continuing-education/itt-technical-instit/itt-technical-institute-teach-bb393.htm>

accelerated in Q1 from 34.77% to a high of 40.84% in Q4, making yoy comparisons that much more difficult.

- There remains little, if any, doubt in our mind that the reform-minded posture at the DOE remains intact, despite misinformation by Credit-Suisse to the contrary that rallied the group last week. We are very confident the DOE, independent of Congress, will have sufficient latitude on the regulatory front to fundamentally alter, or dare we say, dismantle the for-profit education model. With the potential for Pell Grant abuse by the sector, we believe Congress and/or the SEC will investigate these issues prompting further investigation by the DOE and/or GAO.
- The May 4th airing of “Frontline” could be a game-changer across the space. In our view, there is a lack of understanding at the Congressional level. It’s possible we’ll get a repeat of the CECO experience following the *60 Minutes* piece about the industry a few years back. This Congress is more likely to follow through and dig deeper into the issues.

The Bull Case (Ground Campus, Repurchases and Direct Loans)

- **Private Student Loans:** At 12/31/09, ~\$56 million of private education loans had been made under the Private Student Loan Program. ESI has \$300M available for what we call “bridge loans.” The standard repayment term for a private education loan made under the Private Student Loan Program is ten years, with repayment generally beginning six months after a student graduates or *three months after a student withdraws or is terminated from his or her program of study.*
- It’s well advertized that ESI is buying its revenue its stream by filling a relatively small gap between tuition costs and federal loans. In effect, if tuition is \$10k and federal programs only covers \$7500, ESI could be providing a \$2500 loan to fill the gap. We believe, the company, and industry, is more than willing to make loans directly to students to grow their business, even though the collectability of the bridge loan may be slim to none. Then why do it? The school obviously wants the Title IV for revenue recognition purposes. They are willing to write-off completely or collect a fraction of the bridge directly from the student. Hence, the italicized phrase of 3 months after the student withdraws. Like APOL this begs the question: How many students are withdrawing? Obviously, tracking accounts receivables and bad debt gained increasing relevance over the last 2 years since SLM slowed its participation in the private loan market. (See below re STU’s eps 4/19)
- At \$56M of loans made directly to students in 2003, how many students could be recruited under this program? Management has been rather elusive in describing the loan amounts per student and numbers of students by quarter. If new enrollments for the year were 86k vs. 65k in 2009 vs. 2008, up 21k, the average loan amount, assuming all new students received bridge financing would be ~\$2600 (56M / 21k). To the extent, the bridge loans could be lower; management would have much greater control over its growth. Not all new enrollments are bridge recipients. Pools of existing students may be beneficiaries of these bridge loans helping to maintain “retention.” For illustration, we chose a range of average loan amount from \$2700 down to \$1400.

<u>Avg Loan (\$)</u>	<u>Students Recruited</u>	<u>Avg Loan (\$)</u>	<u>Students Recruited</u>
2,700	20,741	2,000	28,000
2,600	21,538	1,900	29,474
2,500	22,400	1,800	31,111
2,400	23,333	1,700	32,941
2,300	24,348	1,600	35,000
2,200	25,455	1,500	37,333
2,100	26,667	1,400	40,000

The following table sets forth new student enrollment in the periods indicated:

New Student Enrollment in the Three Months Ended:	<u>2009</u>		<u>2008</u>		<u>2007</u>	
	<u>New Student Enrollment (1)</u>	<u>Increase Over Prior Year (1)</u>	<u>New Student Enrollment</u>	<u>Increase Over Prior Year</u>	<u>New Student Enrollment</u>	<u>Increase Over Prior Year</u>
March 31	18,935	36.8%	13,844	8.7%	12,738	13.1%
June 30	19,692	33.5%	14,751	22.5%	12,043	3.2%
September 30	27,738	27.2%	21,807	19.4%	18,270	8.8%
December 31	19,563	31.2%	14,911	29.2%	11,542	13.1%
Total for the year	85,928	31.6%	65,313	19.6%	54,593	9.3%

- Bad debt expense as a percentage of revenue increased to 6.2% in the year ended December 31, 2009 compared to 4.3% in the year ended December 31, 2008, primarily as a result of increases in the amount of internal student financing that ESI provided to its students. That's \$79m of bad debt vs. \$56M, up \$23M, vs. \$56M bridge loans made directly to students. Tough call but given the volatility it won't take much to move the needle toward lower eps due to higher bad debt. Bad debt expense as a percentage of revenue will be in the range of 4% to 6% in the fiscal year ending December 31, 2010. At 20% growth in 2010, revenue will be in the range of \$1.5 billion, resulting in a \$93M of bad debt expense (at 2009 bad debt expense rate of 6.2%). Assuming the same ratio of bad debt to bridge loans of 141% that implies \$66M of direct loans to students. That's fairly low given they have up to \$300 to spend.

Quarterly Revenue (Dollars in thousands)

Three Months Ended	<u>2009</u>		<u>2008</u>		<u>2007</u>	
	<u>Amount</u>	<u>Percent</u>	<u>Amount</u>	<u>Percent</u>	<u>Amount</u>	<u>Percent</u>
March 31	\$ 288,033	21.8%	\$234,850	23.1%	\$204,170	23.5%
June 30	317,140	24.0%	246,411	24.3%	216,982	25.0%
September 30	339,643	25.8%	254,273	25.0%	217,932	25.0%
December 31	374,378	28.4%	279,799	27.6%	230,424	26.5%
Total for Year	\$ 1,319,194	100.0%	\$ 1,015,333	100.0%	\$869,508	100.0%

	Year Ended December 31,		
	2009	2008	2007
Revenue	100.0%	100.0%	100.0%
Cost of educational services	34.1%	37.8%	41.3%
Student services and administrative expenses	28.8%	30.1%	30.8%
<i>Operating income</i>	37.1%	32.1%	27.9%
Interest income, net	0.2%	0.2%	0.3%
Income before income taxes	37.3%	32.3%	28.2%

Share repurchases (more of an annoyance worth mentioning)

- In January 2010, ESI authorized to repurchase an additional 5.0 million shares of stock. From February 3, 2010 through February 17, 2010, ESI repurchased 562,500 shares for a total cost of \$54.0M. In 2009, ESI repurchased approximately 3.5M shares for approximately \$348.1 million compared to approximately 1.0M shares for approximately \$87.8 million in 2008. The following table sets forth share repurchase activity during 2009, 2008 and 2007:

	Year Ended December 31,		
	2009	2008	2007
Repurchase authorization at beginning of period	3,972,100	5,021,800	2,681,100
Additional repurchase authorization	--	--	5,000,000
Number of shares repurchased	(3,477,875)	(1,049,700)	(2,659,300)
Repurchase authorization at end of period	494,225	3,972,100	5,021,800
Total cost of shares repurchased (in millions)	\$348.1	\$87.8	\$265.0
Average cost per share	\$100.10	\$83.62	\$99.65

Threat to Bear Case: Expanding Ground Campus Footprint

- ESI has an 11% organic growth rate from new locations. Pressing the pedal on new locations could bolster ESI's growth. At 12/31/09, ESI had 125 locations (121 campuses and four learning sites) in 38 states. In 2009, ESI began operations at ten new campuses and converted five learning sites into five ITT Technical Institute campuses. In 2009, ESI added a total of 377 programs among 106 campuses, and in 2010 added more programs among approximately 95 locations. ESI currently offers one or more of our online programs to students who are located in 48 states and the District of Columbia. In 2009, ESI increased the number of campuses that offer bachelor degree programs from 87 to 102. In 2010, ESI intends to add more program offerings among ~95 locations and intends to open 8-10 new campuses. New campuses generally incur a loss up to 24 months.

	Year Ended December 31,		
	2009	2008	2007
Additional program offerings	377	190	246
Number of campuses and learning sites with additional program offerings	106	71	85
Began operations at:			
New campuses	10 (1)	8	10
Converted learning sites to campuses	5	--	--
Campuses offering bachelor degree programs	102	87	73

Recent Credit Suisse Conference ...

- **Q:** what are you seeing with our 2010 internal goals in terms of the 30% increase in EPS
- **Mgmt:** Just in general, as we think about scholarship levels, again I mentioned in our January call, we will have a 5% price increase in March. Although when you think about the really effective tuition increase, when you look at revenue per student per year, you'll likely see that being pretty close to *being flat*; and that's as a result of the increased utilization of institutional scholarships. There'll be a tuition increase, pretty much give that back in terms of the increased utilization of the scholarships.

Q4 2009 Earnings Call Notes

- As a result of the addition of the three new campuses and the conversion of the five learning sites into full campuses in the 2009 fourth quarter, we had 121 campuses and four learning sites in operation as of December 31, 2009 (sic) [2009]...Our goal for 2010 is to begin operations at eight to 10 additional locations pending receipt of all of the requisite regulatory authorizations.
- We continued to experience a very favorable advertising environment, although we are beginning to see some signs of stabilization in the yoy cost for each advertising placement. Advertising expenditures increased approximately 12% in the 2009 fourth quarter compared to the same prior-year period. We believe that our advertising expenditures will increase approximately 15% in 2010 compared to 2009. The response rates to our advertising continued to be strong in 2009's fourth quarter and we believe that it will remain strong well into 2010. Recruiters were up 15%.

Growth in Pell

- As in prior APOL reports, we would draw investors attention to the growth Pell grants and Pell recipients. Notice there is a seasonality impact of heavily weighted Q4 disbursements (generally made twice a year), however, the yoy Pell growth is twice that of sales. Also, notice the total Pell recipients for the 4th quarter was 47k, while total enrollments were 80.7k and new enrollments were 19.5k. We believe the industry's aggressive posture toward recruiting low-end students is a high risk shift in the business model and not one that can easily be reversed.

	4q09	3q09	2q09	1q09	4q08	3q08	2q08	1q08
ESI								
Rev (from Tuition only, if reported)	374,378	339,643	317,140	288,033	279,799	254,273	246,411	234,850
Total Enrollments	80,766	79,208	69,889	65,620	61,983	61,556	54,793	54,194
New Enrollments	19,563	27,738	19,692	18,935	14,911	21,807	14,751	13,844
Total Undergrad Enrollments								
New Undergrad Enrollments								
Pell Disbursements								
Pell Disbursements	\$99,126,399	\$47,503,180	\$34,959,088	\$35,082,912	\$56,604,456	\$21,942,413	\$23,259,063	\$24,030,621
Pell Recipients	47,213	24,313	24,846	27,023	32,575	13,145	17,200	19,225
Seq Ch (%)								
Rev (from Tuition only, if reported)	10%	7%	10%	3%	10%	3%	5%	2%
Total Enrollments	2%	13%	7%	6%	1%	12%	1%	2%
New Enrollments	-29%	41%	4%	27%	-32%	48%	7%	20%
Total Undergrad Enrollments								
New Undergrad Enrollments								
YoY Ch (%)								
Rev (from Tuition only, if reported)	34%	34%	29%	23%	21%	17%	14%	15%
Total Enrollments	30%	29%	28%	21%	17%	15%	12%	10%
New Enrollments	31%	27%	33%	37%	29%	19%	22%	9%
Total Undergrad Enrollments								
New Undergrad Enrollments								
Pell Disbursements								
Pell Disbursements	75%	116%	50%	46%	74%	2%	29%	21%
Pell Recipients	45%	85%	44%	41%	41%	-11%	4%	34%

STU Dire Prediction for Private Loan Collections (4/19/10 EPS)

- “The Company's allowance for loan losses at March 31, 2010 was \$173.2 million, an increase of \$24.1 million compared to \$149.1 million at December 31, 2009. This increase reflects continued performance deterioration from the economic environment, seasoning of the uninsured CitiAssist Standard portfolio, \$6.3 million of additional reserves for newly consolidated securitization loan assets and \$5.1 million associated with private education loan forbearance policy changes. These policy changes will result in the Company *limiting its borrower assistance programs and are expected to materially increase credit losses beginning in the fourth quarter of 2010*. Net credit losses increased by \$6.7 million (33%) during the first quarter as compared to the same period in 2009 primarily due to seasoning of the Uninsured CitiAssist Standard portfolio.” This could be an indicator of ESI's collection / write-off patterns.
- Interestingly, with the allowance for loan losses at \$173M vs. \$149M up 16% sequentially, private education loans were \$9.9 billion up from \$7.4 billion, up 33% sequentially. Yet, the company is saying they are going to limit the program in 2H10? For the quarter, net interest income was \$256M vs. \$204M. Provision for loan losses was \$43.8M vs. \$21.1M.

ITT Technical Institute Recent Complaints

We realize that placing any faith in postings on the various consumer complaint message boards is well...to be taken with a grain of salt, we still want to keep an eye on them. Across the industry the same complaints show up time and time again. Not all of them can be wrong or lying. Interpret at your own risk.

Former EC Complaint³

I was an admissions advisor and I am writing this because sometimes you are going to read positive remarks from current students(All these encouraging comments are from fake students and are actually paid by ITT Tech to say bogus and phony messages) In the year I was working for ITT TECH I have only heard complaints from students.

I am working for ITT and I know what's going on, everybody knows ITT-TECH and their fabricated information and invented reports, I am surprised they still in the education business, they should be in the Sublime loans or any fraud and unethical business. The only concern of the management in the HQ is to increase profits and do not care about students, I believe ITT Tech soon will go down because I know about many lawsuits waiting for ITT. Here is the main problem with this company -- they are extremely misleading and what they describe as their "Mission Statement" and what is being said and reviewed behind closed doors is the definition of hypocritical. They claim to be changing students lives (yes this is true will bleed you dry, ITT TECH is nothing but money launderers, it is a mafia) at ITT TECH You are not a student -- you are a "start number". Absolutely, no good reasons to work for this unethical institute, most horrible management practices, bogus and fake reports and information about the company. Who would have thought that ITT TECH can be permitted to be up and running with so many , morals complaints, ethics violations, and educational deception and hoax. I totally agree, ITT TECH is nothing but money launderers, you are not a student you are a "start number" ITT TECH is a big MAFIA.

Teachers must make quota of student attendance and pass class Internet 3/03/10⁴

Teachers at ITT Tech must reach a quota of student attendance AND pass a certain number of students in each class to keep teaching the class. For example, TB133 (the first class a student takes at ITT) must have student attendance and success rates (total number of students that started the class and passed) of around 75%. This number is supposedly calculated from a national average of that class's (TB133) numbers the preceding quarter. This practice started about two years ago and the ramifications of not making the number has increased. What started as a gauge to see where improvements could be made to instruction has escalated into teachers being reassigned or let go. This information has been sent to ITT's accrediting body ACICS around a year ago, but no action has been taken by them to date.

Poor Quality Education, Inflexible System Posted March 2nd 2010⁵

I finished up a two year degree in Computers and IT at a two year college and decided to further my education by returning to school for a Bachelor's at ITT Tech. I began speaking with my recruiter, who was very pleasant but pretty much rushed me into a meeting with her. I met with

³ <http://www.indeed.com/forum/cmp/ITT-Technical-Institute/ITT-Tech-Is-SCAM-DON-T-DO-IT/t42772>

⁴ <http://www.ripoffreport.com/adult-career-continuing-education/itt-technical-instit/itt-technical-institute-teach-bb393.htm>

⁵ <http://www.complaintsboard.com/complaints/poor-quality-education-inflexible-system-c317307.html>

the recruiter and I took the entrance exam, yes ITT Tech actually has an entrance exam, after I passed I was shown a nice powerpoint that pretty much made me feel like this was the perfect decision to make. When I told her that I already possessed an associate's degree in IT work she basically told me, "too bad, tough luck." I was then informed that I would have to repeat the associates program through ITT Tech... On the first day of class we were having lecture and all of a sudden a group of people over in the corner were beginning to get kind of loud. Our teacher called over to them, "Can you guys quiet down, I'm trying to teach a class." One of them replied with, "So am I." ITT actually scheduled more than one class in that room at one time. That's just the tip of the iceberg, we only had access to the lab for an hour and a half before moving into a lecture room for the rest of class.

One day I got to school early and plugged in my netbook at a station and then a staff member kicks me and another student out of our room so that they can have a faculty meeting in there. That one sent me over the top. I sent the nastiest e-mail I think I've ever written to ITT's feedback line detailing just about every problem I have listed in this complaint. A week later I got a call from my department head telling me he needs to meet with me. I met with him and the Associate Dean. They told me I had to appologize for the letter I had sent. I appologized for the language I used, the worst of which was the word "stupid". The Associate Dean told me that our campus was not over capacity and that all ITT Tech schools practice the class rotation system. She said there aren't enough computers for all the students to have access to one, thanks for stating that obvious point, so we have to rotate out. If they are lacking that many computers then I think they need to get more computers, not limit our time on them

Waste of money⁶ (Posted 3/5/10)

ITT Technical Institute is a joke. One would be better off taking a fake bank to the check, take \$100 of \$5000 and send the rest to some anonymous address overseas. I taught at ITT a couple of years ago and trust me it is all about the students. The students can do whatever they want and still pass. One student came once out of 11 weeks and got an A. One of the deans changed the grade. At the ITT in Maryland, most of the students cannot read and write. And they are always questioning the instructor and complaining to the dean. The instructor's work area is ridiculous, as there are "new computers" running XP with no service packs. Student computers are even worse. The cost for this college is unbelievable, as \$40,000 will earn an associate degree to nowhere. It is unaccredited, but with ITT's purchase of an accredited college last summer, they can claim accreditation. It is more or less a camp for mostly adults who cannot go to real college. I did encounter some students who really did want to learn and I told them to go to a real college.

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⁶ <http://www.complaintsboard.com/complaints/waste-of-money-c318568.html>