The Deal Pipeline

For-profit schools face a harsh education

By Jamie Mason   Updated 11:55 AM, May-09-2014 ET

School is almost out for summer, but some for-profit post-secondary education companies are already worried about the fall.

Declining enrollments and regulatory issues have recently led two major players in the industry to take stock of their situation. Education Management Corp., the second-largest for-profit post-secondary educator in the U.S., on May 1 hired Evercore Group LLC as its financial adviser and is now talking to its lenders. And on Tuesday, Corinthian Colleges Inc. announced that it would begin exploring its strategic alternatives with the help of Barclays Capital Inc.

More for-profits could find themselves in trouble, too. The space sounds as if it's occupied more with economists than it is with educators, because terms such as cohort default rates and gainful employment and 90/10 requirements roll off the tongues of administrators. These are regulatory terms, and the reason they are now so important is because for-profits' compliance with them is vital to their survival. And that's becoming a more arduous task.

Then there's the enrollment problem. For-profit enrollments last year declined 9.7%. The situation is likely only to get worse. The eligible population going to for-profit schools has dwindled appreciably and the students aren't considering these schools as much as in past years, according to Vic Datta, a senior managing director at FTI Consulting Inc.

Undergraduate and graduate students are shying away because they can't afford the student loans and interest on those loans have doubled, he said, and because of more onerous regulations, students don't know if the school is going to go under and render their degree meaningless. The beneficiary of all this has been state schools, where more and more students are now matriculating, Datta said.

Some for-profits have filed for bankruptcy already. ATI Enterprises Inc., which was owned by private equity firm BC Partners Ltd., filed for Chapter 7 in the U.S. Bankruptcy Court for the District of Delaware in Wilmington on Jan. 21, months after being hit with a $3.7 million judgment by the U.S. Department of Justice for allegedly inflating its job placement statistics. Secured lender Royal Bank of Canada had foreclosed on some of the company's assets. ATI has since liquidated.

RESTRUCTURING PROFESSIONALS believe other distressed for-profits will try to avoid bankruptcy, however.

"Instead of more traditional restructurings, it's likely to be out-of-court restructurings, liability management, cost cutting, shutting down campuses and consolidation," said Eric Winthrop, managing director at Houlihan Lokey Inc. "The smaller companies with fewer campuses that become troubled will likely shut down or sell off campuses, while the larger companies in the space will work their way out of distress by modifying programs, closing campuses and cost cutting."

Enrollments in for-profits hit their highest point in 2010 at 3.9 million students, which was 13% of the total population of post-secondary students in the U.S. There are roughly 3,400 for-profits operating in the U.S., and some have hundreds of campuses. One of the oldest and best-known for-profit brand is DeVry University, a division of Downers Grove, Ill.-based DeVry Education Group. In recent years, though, Phoenix-based Apollo Education Group Inc. has grown into the industry's largest company on the strength of its University of Phoenix brand, which boasts an overall enrollment of approximately 250,000 students.

But to understand for-profits, you have to know the economics behind them. Title IV funding, which is financial aid from the federal government in the form of Pell Grants and other programs, is a key lifeline. EDMC, for example, derived roughly 80% of its net revenue of $2.49 billion in fiscal 2013 from Title IV funding.

When it comes to Title IV, for-profit schools need to comply with a so-called 90/10 rule, which requires that no more than 90% of a for-profit school's revenue can come from Title IV while the remaining 10% needs to come from other sources. The U.S. Department of Education also uses a composite score to evaluate the financial health of a school because it wants to know that the institution is financially healthy enough in case the government needs to claw back its financial aid money, according to **Joe D'Angelo, a partner at Carl Marks Advisors**.

An increase in regulation for for-profit schools started in 2010 when the Health Employment and Pensions Committee, known as the HELP committee, issued a report which found that the for-profit education sector represented about 11% of total enrollments but contributed 50% of the student loan defaults, **D'Angelo** said.

"Seeing as how Title IV financial aid is taxpayer money, the findings led to further scrutiny and increased regulation," he added.

Now the education department looks at cohort default rates, which is the percentage of a school's borrowers who enter into repayment on their loans but later default on them. It also will study gainful employment rates, which focus on a school better preparing students for getting jobs that will enable them to repay their student debt.

The Education Department late last year issued a report which found that the two-year cohort default rate for for-profit schools was about 14% — nearly triple traditional private schools' 5% and higher than traditional publics' 10%.

But the gainful employment rules, which emerged in March and will go into effect next year at the soonest, could prove decisive in the fate of for-privates.

According to **D'Angelo**, the new proposed gainful employment regulations for for-profits require three categories of compliance. The first one — accreditation — isn't a new hurdle, since schools need it to qualify for Title IV financial aid anyway. The second one requires schools to provide metrics showing that their students' debt-to-total income is not be more than 20% and that repayments are not be more than 8% of the student's disposal income. The third and last rule is that cohort default rates cannot be greater than 30%.

SO KEEPING THE flow of Title IV money coming for for-profits means complying with expanding regulations and staying out of bankruptcy, since a filing automatically cuts off a for-profit school's access to the financial aid. As a result, out-of-court restructurings are likely to become only more prevalent.

"There likely won't be much restructuring activity in the traditional sense because bankruptcy generally results in a liquidation for these companies," said Houlihan's Winthrop. "Most of the companies that have entered into Chapter [7 or 11] in my experience have liquidated because once in bankruptcy, these companies lose their Title IV funding, which can represent more than 80% of the funding students rely on to pay for their education."

Plenty of candidates for out-of-court restructurings exist. Besides EDMC and Corinthian, there's Cypress, Calif.-based Trident University International and Carmel, Ind.-based ITT Educational Services Inc. In addition to disclosing in early April that its lenders agreed to waive the maximum leverage ratio covenant for the fiscal quarters ending Dec. 31 and March 31, ITT faces a lawsuit from the Consumer Financial Protection Bureau.

The typical catalyst for restructurings for for-profits is a violation of covenants, "but a watch on cohort default rates is also driving a lot of restructuring as well," FTI's Datta asserted.

Santa Ana, Calif.-based Corinthian disclosed on May 6 that it has breached certain covenants on its debt and is in talks with its lenders about obtaining a waiver. The company has a $145 million credit facility with Bank of America NA that matures on July 1, 2015.

During its fiscal third-quarter earning call on May 1, Pittsburgh-based EDMC, the operator of 110 locations in 32 states and Canada through the brand names Art Institutes, Argosy University, Brown Mackie Colleges and South University, said that it wasn't likely to satisfy its financial covenant compliance ratios as of June 30.

Owned by a consortium of private equity investment funds led by Providence Equity Partners, Goldman Sachs Capital Partners and Leeds Equity Partners LLC, EDMC's balance sheet is larded with a roughly $1.27 billion debt load from its March 5, 2006, leveraged buyout. Approximately $732.4 million of its debt is set to come due on June 1, 2016.

"EDMC has been having a tough time this year," said Standard & Poor's analyst Christopher D. Thompson. "They are at risk of violating their total leverage covenant on their term loan and had only a 1.7% cushion on the covenant as of Dec. 31, 2013, so there is very little room for error in their operations. The company's interest coverage covenant is also tight. The company's covenants have been getting tighter over the last few years. The degree of their covenant cushion has been deteriorating because of enrollment declines, but this is the most trying part of the company's history so far because they are experiencing significant enrollment declines."

Worst still, because of EDMC's low score in the Education Department's evaluation system, it has to maintain a letter of credit of 15% against its Title IV funding.

"It's a horrible use of capital," noted **Carl Marks' D'Angelo**. "EDMC has something like a $475 million cash collateralized letter of credit just to be able to collect $2 billion in Title IV revenue every year."

But things are only going to get more complicated for for-profits because of the increased requirements being thrust at them, especially when gainful employment rules become a reality.

"For-profit schools represent 7% of student intake but approximately 30% of defaults of the total $100 billion in student loan defaults, so it's a clear and present issue," Datta said. "Gainful employment rules are going to require these schools that take federal funding to have a commitment to their students and show that the student will be able to get a job in their field that will help them pay off their loans."

In the wake of regulation, schools have been forced "to be more selective in their recruiting because you have all of these student outcome measures now in the regulations," **D'Angelo** explained. "Between 2010 and 2012, they added a lot of students that should not have been admitted. They were very aggressive when the natural enrollments started dropping. They aggressively targeted people that were eligible for the most financial aid and probably knew were not going to finish their programs. That is part of the scrutiny."

ONE THING FOR-PROFITS don't need are more probes into their business processes. Many of them already have their hands full legally.

On Jan. 24, for example, EDMC disclosed in filings with the Securities and Exchange Commission that it has received inquiries from 12 states regarding the company's business practices, including those relating to the recruitment of students, graduate placement statistics, graduate certification and licensing results, and student lending activities, among other matters.

Schaumburg, Ill.-based Career Education Corp., which has more than 50,000 enrollees and operates in 15 states, has received inquiries from 12 state attorneys general regarding its business practices.

Meanwhile, Corinthian Colleges' business practices are being probed by 13 states: Arkansas, Arizona, Connecticut, Idaho, Iowa, Kentucky, Missouri, Nebraska, North Carolina, Oregon, Tennessee, Washington and Pennsylvania. Corinthian Colleges is also facing a civil complaint that was filed by the Massachusetts Attorney General's Office after an investigation of the company that began in April 2011.

All of the schools have said they would cooperate with the investigations.

ITT Educational Services has received subpoenas and civil investigative demands from the attorneys general of Arkansas, Arizona, Connecticut, Idaho, Iowa, Kentucky, Missouri, Nebraska, North Carolina, Oregon, Pennsylvania and Washington. The Consumer Financial Protection Bureau also sued ITT Educational Services on Feb. 26 in the U.S. District Court for the Southern District of Indiana in Indianapolis.

In the suit, the bureau accused the company of predatory lending and said in a press release on the same day that the legal action should "serve as a warning" to other for-profits.

ITT Educational Services is seeking to dismiss the lawsuit, claiming that the bureau's allegations are legally flawed and unconstitutional. The company is arguing that it "does not provide consumer financial products" and that "the complaint recognizes that the loans at issue in this case were made by third parties — not ITT."

"A lot of these companies have issues that are more regulatory in nature, such as lawsuits and investigations for bad business practices," said Winthrop, the Houlihan managing director. "These issues are causing distress in the industry because if they get hit with a big judgment, it raises the question of how they will continue to fund their business."

Others agree. "The lawsuits will be catalysts for restructurings," **D'Angelo** noted.

While some litigation will probably be solved by a settlement and no admission of wrongdoing, **D'Angelo** said he is worried "that they may have evidence that can turn the damages number into something that someone is not going to be able to just write the check for."

The restructurings of for-profits so far have been mostly operational, but they have had symbolic significance for an industry whose collective strategy has been to expand — more campuses, more programs and more diplomas. "It's not the mindset of these operators to be scaling back," **D'Angelo** noted.

There is an economic basis for the for-profits' grander designs.

"A campus looks like a fixed-cost business when the building is underutilized. Like an airplane, if you don't fill the seats, you don't make money," **D'Angelo** explained. "When you get below a certain fill rate, you are unprofitable until you cover the campus rent. Once you cover the rent, then your Ebitda at the campus level starts growing again."

As a result, for-profit schools are making a variety of operational changes in an attempt to both comply with regulation and improve their revenue. Schools are modifying programs and re engineering the student's end-to-end experience — from admission to graduation to job placement.

In the past, for-profit schools spent considerable sums on student acquisition costs, namely buying lists of potential students and then calling them. Roughly 15% to 20% of revenue was spent on such lists. But for-profits are moving away from cold-calling students and instead are looking at generating demand through community outreach, giving demonstrations to prospects by enlisting the help of inspirational authority figures, such as clergy, lawyers and school commissioners, Datta pointed out.

"Schools have had to rationalize programs and when you cancel a program, you are reducing your revenue. They also have had to be more selective on admissions, which is putting more downward pressure on revenue," **D'Angelo** said.

A brighter economy has been a double-edged sword for for-profits, on the one hand helping admissions recover but on the other stealing candidates who will grab jobs that are now available.

"While the [enrollment] decline is decelerating, as the economy improves, there will likely be a negative impact for for-profit schools because there will be more jobs available so people won't want to go to school if they can get a job right out of high school or already have a job," said Moody's Investors Services Inc. senior credit officer, Carl Salas.

The changing enrollment picture has for-profits reassessing their physical plant, too. By law, schools that take Title IV funding must teach all enrolled students through graduation before they close — a process known as a teach-out. So shuttering campuses isn't a quick cost-cutting option. A school can stop enrolling new students but it must continue to instruct and maintain services for enrolled students.

"It's not in an operator's mindset to close a campus, and the prohibitive factors of closing a campus are the costs of the teach-out and the fact that you may still have a remaining commitment on the lease," **D'Angelo** said.

COMPLICATING THE CAMPUS situation further is the rapid rise of online education "because it takes students away from campuses," Winthrop said. "Since it's not easy to shut down a campus, schools are struggling with how to create hybrid programs to use campuses and, in some cases, shutting down campuses that aren't being utilized."

That more teach-outs may be coming is a good and bad thing. "Teach-outs are just starting," according to Datta. "I would anticipate that in the next year we are going to see more of that, where regional not-for-profit universities will be buying these students. During a teach-out, a school has to find an equivalent in order for the student to finish their degree, which may mean going to another school. If teach-outs are not handled properly, it can have a major brand impact, especially if a university gets slammed on social media. Consolidations are OK in local areas, but these schools try to avoid closing campuses."

Lenders, meanwhile, don't fare well if a campus is closed. "I think that when lenders made these loans, they thought they would have some downside protection in the receivables and didn't realize that when you close a school, those receivables get used up in the teach-out process," **D'Angelo** explained. "There are really no assets. These are cash flow loans."

The schools also don't own their real estate anymore, either. Once land-rich, these schools abandoned their real estate via sale-leasebacks in recent years to improve their liquidity.

D'Angelo points specifically to University of Phoenix, which did 1 million square feet worth of sale-leasebacks in 2009, 2010 and 2011. In 2011 and 2012, EDMC did seven sale-leasebacks, he said.

Meanwhile, having to spend more on students' end-to-end experience with a school is a direct cost of regulation. Schools have to keep students more engaged because they have to reduce drop-out rates and make sure their students can get jobs with the education they obtained.

"Many of these schools are struggling to find programs that students find valuable," Winthrop said. "The schools that are performing the best are the schools that train someone to do something so they can graduate and get a job. For example, a welding school in Texas where students can pay $5,000 for a certificate and immediately get a job on an oil rig making $100,000 offers a great return on investment for the student. Schools that are more liberal arts-focused are generally underperforming."

Datta points to Charles Town, W. Va.-based American Public Education Inc. as a for-profit that has tackled this issue successfully. APE, whose schools are branded as American Military University, American Public University and Hondros College, which have a total enrollment of more than 100,000 students, caters to the military and puts its students through programs that are acceptable to defense contractors within the Washington Beltway.

One way for for-profits to get back to their expansion aspirations and away from regulation is to look beyond the U.S. Many are intent on having campuses abroad.

"These for-profit schools are looking for new and creative ways to make money," said Lawrence R. Perkins, CEO of Sierra Constellation Partners, an interim management and consulting firm. "One of those ways is international and another is online programs."

"Laureate Education Inc. is almost exclusively overseas now because there is a worldwide need for education," Datta noted about the Baltimore-based for-profit, which has campuses in 29 countries. "The University of Phoenix is in the U.K., Mexico, Chile and Australia as well."

Some for-profits, such as Graham Holdings Co.'s Kaplan Education and DeVry, are going even farther around the globe.

"The growth for the larger providers is in international education, where they are expanding programs in places like India and China where the students are eager to learn English for business purposes," according to Moody's Salas.

Perhaps the most logical restructuring move will be for-profits merging operations, programs and campuses.

"Over time, consolidation in the industry will likely be a trend," Houlihan's Winthrop said.

As in all industries, efficiencies would be keen, especially when it comes to Title IV. "We are going to see a lot of schools joining hands in order for these for-profit schools to lower their Title IV funding ratio and get their Title IV funding metric back into check," Datta noted, citing Laureate Education's March 18 deal to buy international business school Thunderbird School of Global Management.

But accrediting body Higher Learning Commission rejected Thunderbird's proposal for a strategic alliance with Laureate in March and Glendale, Ariz.-based Thunderbird said in April that the two had ended discussions.

Already, schools that don't take Title IV funding are in very high demand because it helps a for-profit school stay in compliance with the 90/10 rule.

"Acquisitions make a much bigger impact to maintain compliance then you could ever achieve organically," **D'Angelo** explained.

What might chill consolidation, however, is lenders' reluctance to lend in the for-profit sector. "If you have to provide some liquidity to protect what you are already funding, they would probably choose to fund the acquisitions," **D'Angelo** asserted.

Certainly, lenders to the industry are already nervous.

"I have seen a lot more calls coming in, mostly from lenders," said Datta of FTI Consulting, which provides financial advisory services in out-of-court restructurings as well as bankruptcies. "So far it's been mostly benign operational restructurings and reengineering, [but] the floodgates are going to open and we will definitely see a larger preponderance of restructurings this year and next year, especially in the lower end of the strata that will need to restructure more aggressively."

D'Angelo said there isn't liquidity in the capital markets for for-profit schools right now and the cost of capital has definitely gone up.

"Lenders are very concerned about their brands being associated with companies that are defrauding, or getting accused of predatory lending," he noted. "They also don't want to be associated as a lender that forces the school to shut down and strands all these kids in the community, so they are reevaluating their participation in the space."

It's just another test for for-profit post-secondary educators, who every day are learning hard lessons about a harsher regulatory climate and a shifting clientele.