

## ESI: Closing Out ESI Short Idea with a 100% Gain; Let the Record Show that the Blame for ESI's Demise Lies with Management, Not ED

Company	ITT Educational Services	EPS FY1	N/A	YTD% Change	(-100%)
Ticker	N/A	EPS FY2	N/A	52-Week High	N/A
Stock Price	N/A	P/E FY1	N/A	52-Week Low	N/A
Mkt Cap	N/A	P/E FY2	N/A	200-Day	N/A
Ent. Value	N/A	FY1 EV/EBITDA	N/A	50-Day	N/A
Cred. Rating	N/A	FY 2 EV/EBITDA	N/A	RSI	N/A
Cash/Share	N/A	ROE	N/A	Avg. Daily Volume	N/A
Recommendation	Sell/Short	Target	\$0		

"How did you go bankrupt? Two ways. Gradually, then suddenly"

- Ernest Hemingway, The Sun Also Rises

ITT Educational Services ceased to exist as of September 16<sup>th</sup>. The journey has been the reward... but perhaps not in the way that some might think. Prospectively, we think we will be hard pressed to find an investment idea into which we will put more work and actually witness the predicted outcome. If the objective of any research process is to learn, than our experience with ESI over the past 6-7 years has provided us with a lifetime of knowledge, certainly significantly more than most ITT Tech students received during their time at school. Looking at the stock price chart now, there are many that will be quick to conclude that ESI was an "easy short" for the past 5-7 years. For those who lived through that time period, it was anything but that. It's been a rollercoaster the entire way through. Short sellers endured multiple 50%+ rallies in the stock over the past 5-years and intraday moves in excess of 25% seemingly every time the company reported earnings. ESI's management appeared perpetually focused on squeezing shorts or at the very least maximizing near term EPS at the expense of the long term viability of the franchise. This was never easy.

There are many critics of our work (including management at ESI) that probably think we're happy about the demise of ESI. We're not. The financial impact to investors of ESI's bankruptcy will ultimately be negligible (CUSO and PEAKS holders aside). The repercussions for taxpayers and students will be felt for years, if not decades. It is quite possible that the cost of student loans that are discharged under defense to repayment claims could run into the billions. It seems that many in the media are using the impact to students and taxpayers as reason to criticize the Department of Education for acting to harshly on ESI. Nothing could be further from the truth, in our opinion. It seems that critics of the Department of Education's decision to halt access to federal financial aid for new students at ITT Tech (that's different than shutting the company down) are unwilling to acknowledge the primary role that ESI's management played in the ultimate demise of company. Simply stated, the Department of Education

did not act soon enough and at this stage had no choice but to make the best decision to protect taxpayers and students from further financial harm at the hands of ESI.

Transparency on the returns of our investment ideas is one of the critical principles of PAA Research. We do not attempt to hide our performance. We want the track record of our investment ideas and the quality of our research to serve as our primary client acquisition and retention tool. Nothing less, nothing more. Thus far, our short ideas have performed well. We can still do better. Normally we're not in the business of taking grand "victory laps" on ideas that have worked. However, in this particular case we are deeply disheartened that the narrative around ESI has been twisted such that blame for the company's bankruptcy has been directed at the Department of Education, rather than where it belongs – ESI management. We recognize that the explanation for ESI's failure can become highly politicized, even though there should be little dispute over the events that occurred over the past 5-7 years that ultimately lead to company's bankruptcy. **There are few people in the investment community, political environment, media, or even the Department of Education that have followed ESI as closely as we have over the past seven years. It is not in our nature to be hubristic, in fact we think humility is a central element of sustainable success in the investment industry. However, in this particular case our perspectives on the factors and factual events that actually led to ESI's demise should be considered with significant weight.**

In our view, ESI failed for the following reasons:

- **Tuition was simply too high and ESI failed to adapt to the new demand environment in higher education over the past 5-years.** It is remarkable that ESI management never elected to cut list price tuition. Demand dynamics in the higher education space changed dramatically over the past 5-7 years due to concerns about student debt burdens and affordability. The cost of an associate's degree at ITT Tech based on list price tuition still was \$45,000+ until the day the company shut down. Management elected to use scholarships which were large applied retroactively to help reduce the cost of education. However, the company's list price tuition remained a major impediment to student interest. The company's reluctance to cut list price tuition is one of many examples where management chose to maximize near term profits at the expense of the long term health of the ITT Tech franchise.
- **Educational quality was abysmal.** There's only one metric on which educational outcomes at ITT Tech appear reasonable – the company's self-reported and self-determined job placement rates. Suffice to say, we think regulators, policymakers, students, and investors have good reason to question the veracity of those job placement rates. Otherwise, the company's paltry CAPEX, shockingly low educational services spending, and stunningly high student loan default rates speak for themselves. On a nominal basis, ESI's investment in delivering education at the campus level for the past three years has been on par with that the company spent in the late 1990's. Simply unacceptable. We maintain the view that LIFETIME default rates on federal student loans for ESI approach, if not exceed 70%.

- Management would have you believe that the high default rates are solely a function of their target demographic. The numbers don't support those arguments.
- **The business model was heavily reliant on laying off financial exposure to its students to the federal government and third party lenders.** We would argue that ESI was on the pathway to bankruptcy the second the company started to bear direct financial exposure to the ability of ITT Tech students to pay their student loan obligations. It started with the \$46MM payment to Sallie Mae as a result of a recourse loan program. The PEAKS and CUSO risk sharing student loan arrangements massively increased ESI's leverage in ways that investors initially misunderstood. However, once those programs were exhausted and ESI was left to "self-finance" students on the company's balance sheet, free cash flow generation disappeared. ESI's business model was largely predicated on laying off extreme financial risk on the federal government and for a period of time, private lenders. Once that stopped, so too did ESI's cash flow generation.
  - **ESI's management team squandered BILLIONS of shareholder capital.** Over the past decade ESI spent approximately \$2 billion on share repurchases at an average price exceeding \$75+/share. Since 2009, ESI management deployed more than \$1.2B to share buybacks to help support the stock and boost EPS at a time when industry demand trends and the company's own student starts were deteriorating rapidly. Obviously, had the company deployed that capital towards improving the quality of education at their institutions, introducing new programs, developing new educational platforms, or simply kept it in the bank the company would continue to be in operation today. It should be noted that EPS was a principal determinant of executive compensation for years at ESI. It is any wonder that management consistently pursued strategies that preserved earnings short term and aggressively repurchased stock to boost EPS?

At this stage you might be asking yourself: how could this management team have been so obtuse and reckless with the company and its financial position? Amidst all of our criticisms of ESI's management, a lack of intelligence was not particularly high on the list. Time and time again, the company's executives demonstrated a surprising degree of creativity and guile to avoid regulatory recourse and squeeze more "blood from a stone" from an operating perspective. Unfortunately, rather than address the company's structural issues head on, management elected to use temporary stop-gaps and various forms of operational scotch-tape, which only put the company in a more difficult position in the long run. Why was the company so reluctant to make meaningful changes to the company's business practices and invest in educational quality? We have not had a single conversation with ESI management over the past 6-7 years, but we think there were two critical operating suppositions with which the company's operated over the past 6-7 years:

- **Schemes can be created to avoid regulatory recourse.** Arguably the most notable of these strategies to avoid potential regulatory problems was the PEAKS student loan program, which reduced the company's 90/10 exposure, enhanced cash flow, and lowered bad-debt expense.

We think some investors have forgotten that ESI also was the first to introduce “OPEID gerrymandering”, made a huge push in the military channel to reduce 90/10 exposure, and changed the credit hour structure of some of its programs to improve compliance with the Dept. of Education’s Gainful Employment rule. The list goes on and on...

- **Demand for the company’s programs would recover.** Time and time again, ESI’s management team on its earnings conference calls would remind investors how much operating leverage the company had to an improvement in enrollment trends. The company’s executives were extraordinarily slow to react to the new demand paradigm in the US higher education market, in our view. Unlike other for-profit education companies that have been able to generate better enrollment trends through innovation and new program introduction, ESI’s strategy was largely predicated on slashing costs, reducing educational quality while waiting on a return to a “normal demand” environment. The market clearing price for higher education programs continued to decline over the past 4-5 years and ESI founds itself in a game of “catch-up”. Worse yet, the company’s substandard investment in educational quality resulted in increased regulatory issues, which only further diminished the ITT Tech brand in the marketplace. **Did ESI’s management think they would eventually be able to charge more and deliver less? It appears that way.**

The purpose of this report is to quickly review our history publishing research on ESI and to clarify the reasons for the company’s demise. You might be wondering why we are doing this. **The manner in which the narrative surrounding ESI’s unraveling is framed will likely have a large impact on US higher education policy prospectively.** We are hopeful that anyone who reads this will have a better understanding of the sequence of events that led to the company’s bankruptcy and why we think the Department of Education and other regulators should have acted sooner to protect students and taxpayers from the actions of this management team.

## **PAA Research’s History with ESI**

The CEO of PAA Research, Brad Safalow has been following the for-profit education industry for over 15 years now as an analyst and investor. In February 2009, before PAA Research was founded Mr. Safalow pitched ESI as a short idea to two prominent hedge fund managers. At that time, ESI shares traded north of \$110 and the company had a market cap in excess of \$4 billion. The subject line of those emails read:

*“Short Idea: ITT Educational Services, Inc.’s (ESI) Business Model is Structurally Impaired”*

*-2/22/09*

As long time followers of PAA Research know, ESI was one of the first investment ideas we ever published in the Spring of 2009. Over the past 7+ years, we have continued to recommend investors short shares of ESI. Our conviction was predicated on our extensive primary research about trends in the higher education industry, rigorous accounting analysis, exhaustive reviews of legal and regulatory

filings against the company, an understanding of “game theory” to decipher how the stock would respond to management’s various machinations, and a deep understanding of the credit markets. The issues facing ESI were always hiding in plain sight, despite management’s best efforts to gloss over painful realities or obfuscate them altogether.

**Over the past 6-7 years we published close to 1,000 pages of research on ESI and the for-profit education industry** (this doesn’t include our company specific work on APOL, COCO, DV, and WPO). Quantity is not necessarily an indicator of quality. However, in this particular case we wanted to emphasize how exhaustive our work on ESI has been. **Simply stated there are few people in the US higher education industry, the media, the investment community, Congress, the Department of Education or other regulatory bodies that have followed the developments at ESI over the past 6-7 years as closely and intensely as we have.** It seems like a hubristic statement; we view it as an important observation to be made as you consider our record of the reasons for ESI’s demise.

### **Let the Record Show.....**

*“These unwarranted actions, taken without proving a single allegation, are a “lawless execution,” as noted by a recent editorial in The Wall Street Journal. We were not provided with a hearing or an appeal. Alternatives that we strongly believe would have better served students, employees, and taxpayers were rejected. The damage done to our students and employees, as well as to our shareholders and the American taxpayers, is irrevocable.*

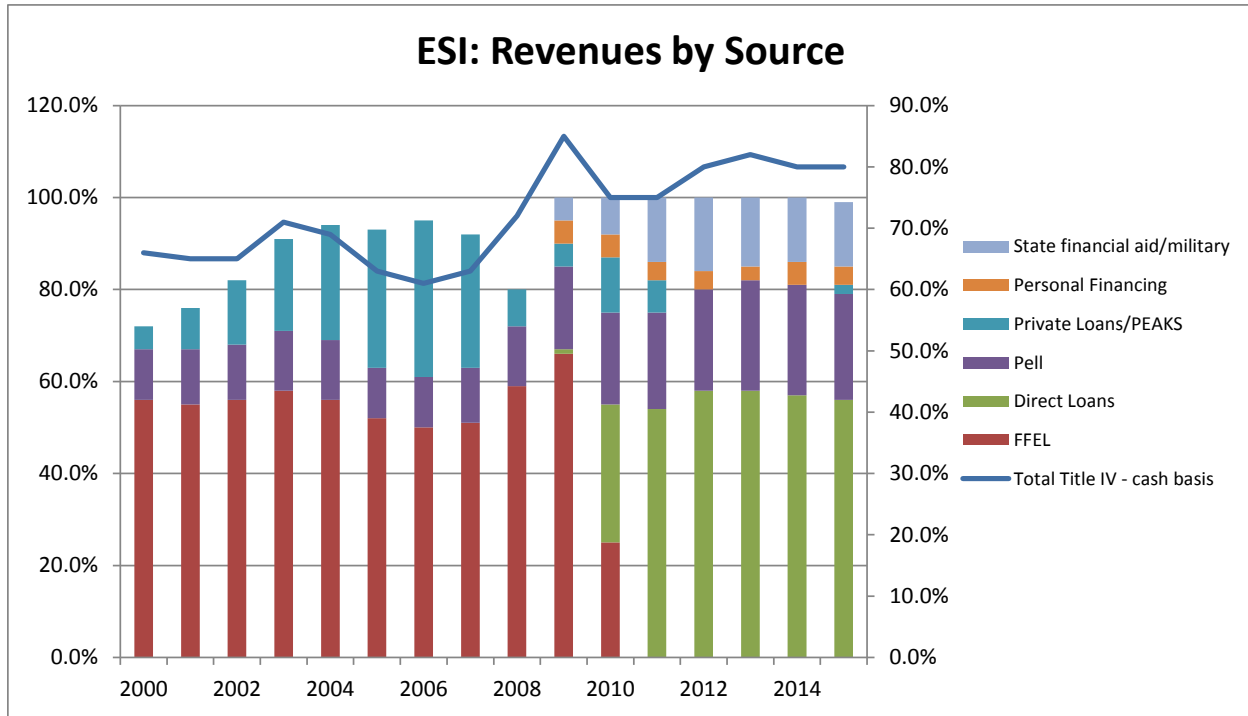
*We believe the government's action was inappropriate and unconstitutional, however, with the ITT Technical Institutes ceasing operations, it will now likely rest on other parties to understand these reprehensible actions and to take action to attempt to prevent this from happening again.”*

- ITT Educational Services Inc. press release 9/6/16

We have to admit, we were somewhat looking forward to ESI’s final press release. The management team has reveled in pointing the finger for its woes at the government, policymakers, accreditors, and various consumer advocacy groups. At no point over the past 6-7 years did ESI’s management team take personal responsibility for the company’s operating issues, regulatory woes, or the substandard outcomes for ITT Tech students. We’re not sure how the Department of Education’s actions were “unconstitutional”, but this press release is filled with so many absurd comments it’s hard to pick any single one out. This press release isn’t quite Rafael Palmeiro waving his finger at Congress, but it’s not far off either.....

Before we get into more detail about some of the FACTS surrounding ESI’s business practices, student outcomes, and management’s track record over the past 6-7 years, we wanted to point out one key data point which should serve as the starting point of any discussion surrounding the company. ESI was almost entirely reliant on funding from government sources: federal financial aid, state grants, and

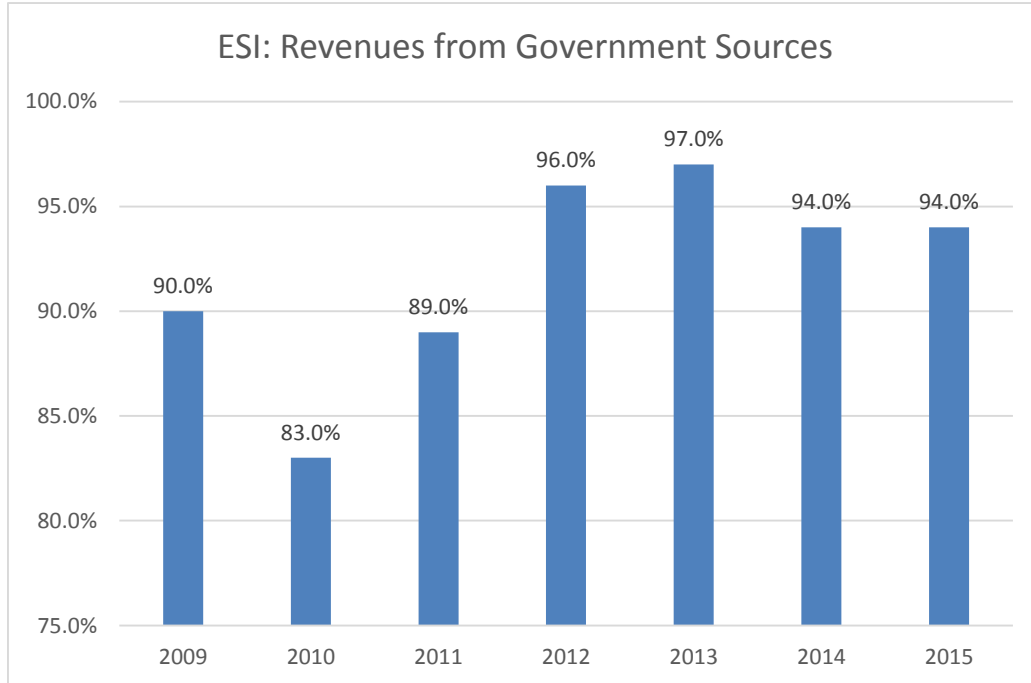
military programs. The company's reliance on government funding increased meaningfully over the past 6-7 years. In the chart below we have outlined ESI's revenue by source.



There are two dynamics that we wanted to illuminate for you. First, ESI's reliance on Pell Grant revenue more than doubled over the past 15-years. **In 2015, ESI generated 23% of its revenues from Pell Grants compared to only 11% in 2000.** The real step function change in ESI's reliance on Pell Grants occurred in 2008. The increase in Pell Grant related revenue was in part a function of expansion of that program, but more importantly a result of the company's decision to target increasingly lower income students to sustain growth. Obviously that strategy did not work as the company's student starts continued to decline at double digit rates over the past 5-years. Worse yet, the decision to target lower income students significantly increased the regulatory risk profile of ESI overall. Presumably, if an organization plans to target higher risk students, one would expect that company to INCREASE its investment in educational services and student support. ESI did the exact opposite, which yielded the expected result-awful outcomes (more on this later).

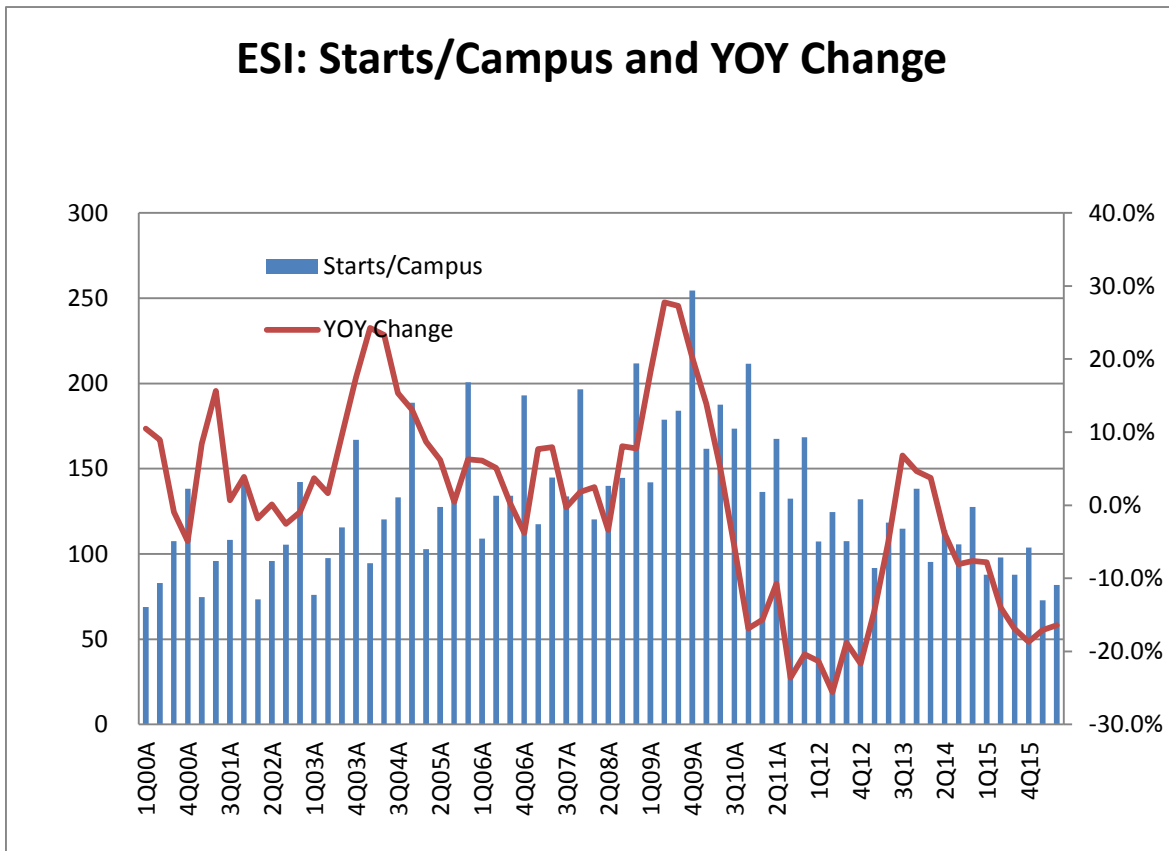
Overall, for the past four years ESI generated approximately 95% of its revenues from federal financial aid, military funding, and state grants. Critics of the Department of Education's intervention on ESI lambast the government for overreaching and compromising the "free market system". When 95% of your revenues are coming from taxpayer supported programs, what about ESI's business should be characterized as "free market"? Paradoxically, Republicans find themselves often supporting organizations such as ESI in the spirit of defending the rights of businesses, the free market, and capitalism, even though you would be hard pressed to find a company that is more dependent on

government subsidies and taxpayer dollars. Some call that “crony capitalism”. This should not be construed as a statement on our political views, merely a presentation of fact.



### **ESI Never Fixed the Core Problem – Students No Longer Wanted to Attend ITT Tech**

In many respects, the simplest explanation to ESI’s failure is that fewer and fewer students wanted to attend ITT Tech. Outside of a period during which the company benefitted from the elimination of a minimum score on the Wunderlich exam required for admission, ESI’s student starts have declined meaningfully in five out of the past six years. Perhaps more importantly, the rate of decline was getting worse, not better. Eventually, persistent inadequate investment in educational quality and poor outcomes resulted in massive reputational damage to the ITT Tech brand. The Department of Education has no direct influence on ESI’s ability to generate lead flow or student starts.

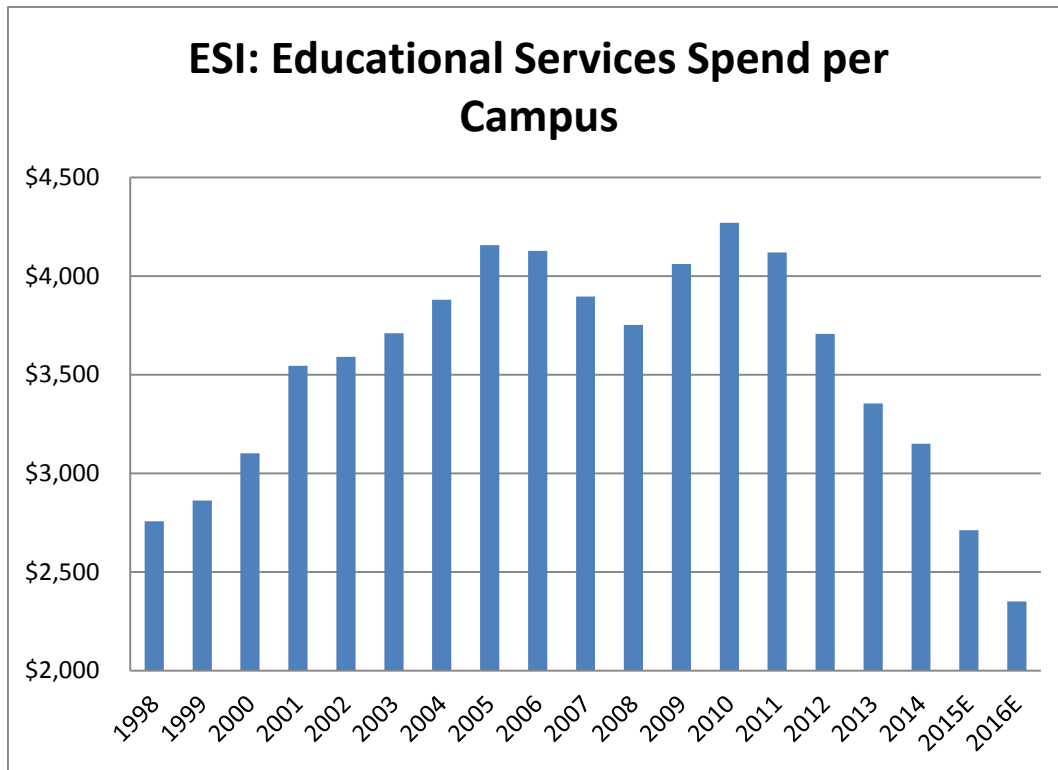


#### ESI’s Investment in Its Educational Programs Was Simply Abysmal

If we’re going to talk about “reprehensible actions” it makes sense to review ESI’s woeful investment in its educational programs over the past five years. As we outlined earlier, the company increasingly targeted lower income students over the past 5-years in an effort to sustain enrollment growth during a period of weakening demand. In addition, to target lower income students, ESI also rolled out nursing programs through its Breckinridge School. Normally, both of these initiatives would typically be associated with higher spending on educational services and increased CAPEX. That is not what happened at ESI.

In the chart below, we have outlined ESI’s educational services spend per campus over the past 18-years. In our view, this is one of the simplest ways to track ESI’s investment in education. Educational services spending per campus is correlated to total enrollment as you might expect, but there is a baseline level of spending one would expect to yield the types of student outcomes that would be deemed acceptable. In 2015, ESI spent approximately \$2.7MM per campus on educational services, which was below that which the company spent on its students in 1998!



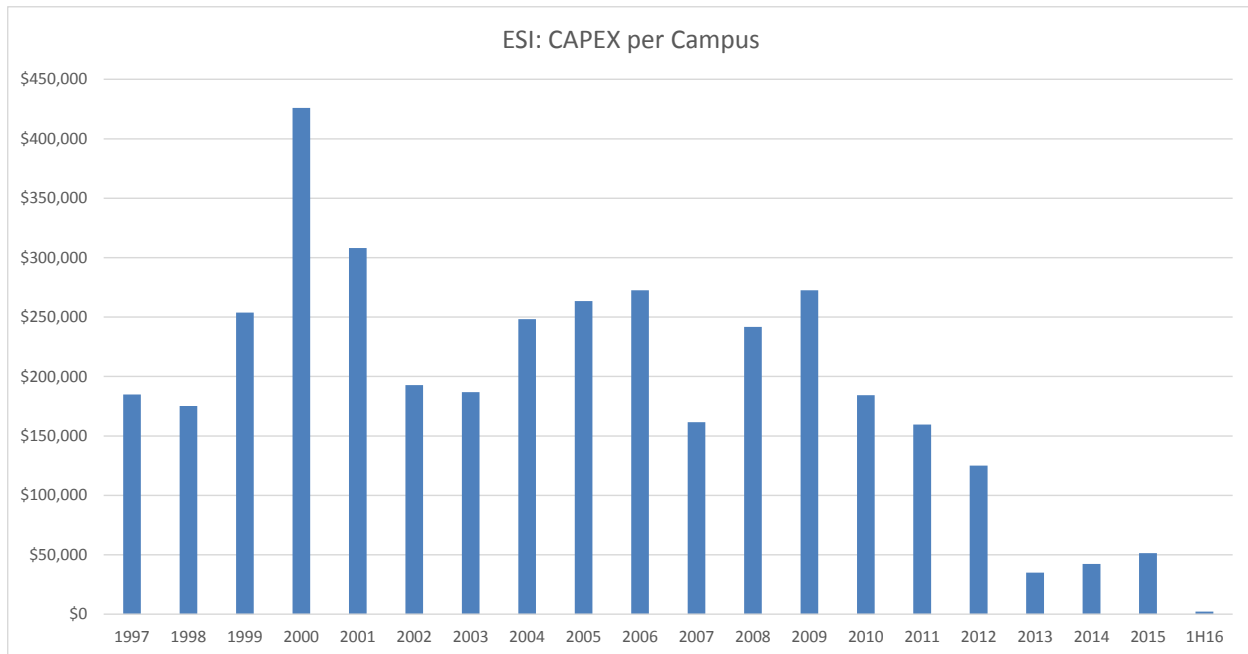


There is another way to look at ESI's "investment" in its students and educational delivery – CAPEX. Historically ESI had been opening new campuses at a pace of roughly 6-8 per year. The CAPEX associated with new openings during that period was approximately \$15-\$20MM. Otherwise, for a long period of time ESI would spend as much as \$15-\$20MM annually on maintenance CAPEX, technology, and new program development. However, over the past three and a half years, ESI aggressively slashed capital spending in an effort to preserve cash flow. From the end of 2012 until the end of the second quarter, ESI spent a TOTAL of \$131,000 on CAPEX per campus. Keep in mind the company's primary programs in technology and more recently nursing require a more material capital investment than other degree offerings. Is it any wonder that student outcomes continued to deteriorate at ESI over the past three years given the company's inadequate investment in educational spending?

Perhaps no observation about ESI's educational services spending and CAPEX investment over the past 3-4 years can be now alarming than the juxtaposition of these two data points:

- ESI CEO salary 2Q16 – Approximately \$200,000
- ESI COMPANYWIDE CAPEX 2Q16 - \$304,000

**That's right, the company's salary for its CEO was roughly on par with companywide CAPEX....**



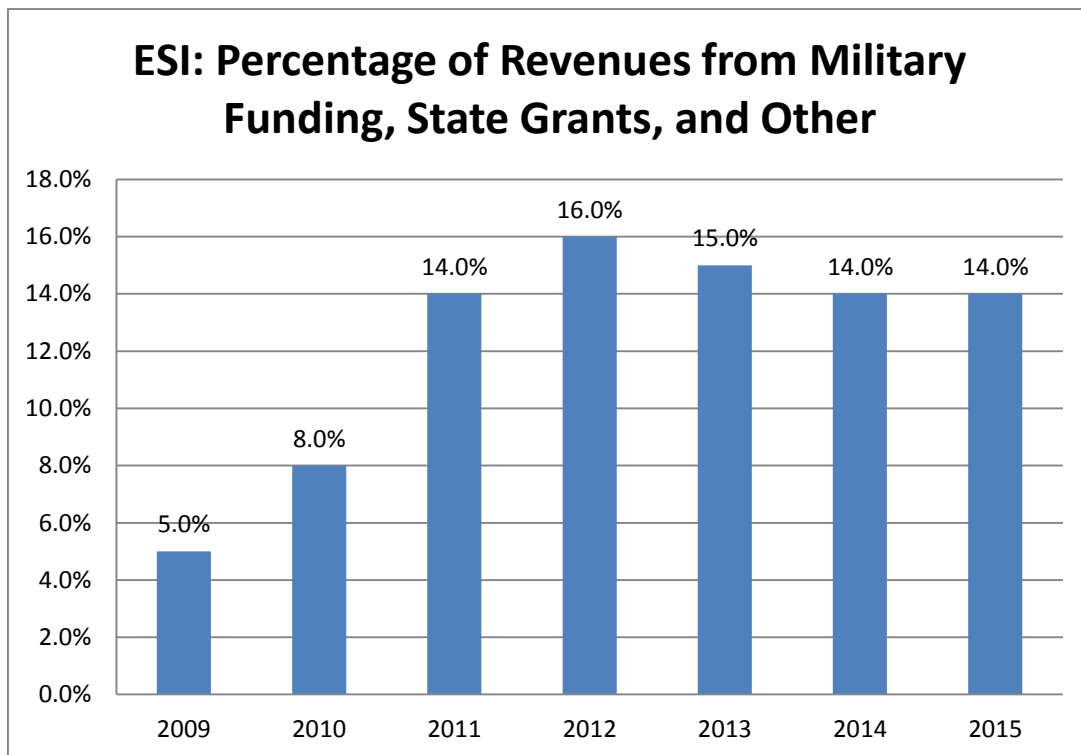
When ESI reported its 2Q16 earnings, the company also announced that it would cut costs even further. In our view, this might have very well been the “straw that broke the camel’s back” as far as the Department of Education is concerned. Simply stated, ESI was exiting the education business for all practical purposes by slashing spending levels even further. In this circumstance, what should the Department of Education do? Allow ESI to draw down \$100MM’s of federal financial aid even though it was obvious to anyone that can read an income statement and cash flow statement that the company was not providing an acceptable educational product? In this context, the Dept. of Education’s decision to act does not seem aggressive at all. There are other for-profit education companies that have chosen to invest and innovate over the past 3-5 years to sustain, if not improve their enrollment trends. ESI’s strategy appeared to be one predicated on the hope that the halcyon days of student demand would eventually return.

### **ESI Consistently Introduced Schemes to Avoid Regulatory Recourse**

It seems somewhat ironic to say now, but one of the things that ESI management excelled at over the years was the ability to avoid regulatory recourse. Realistically speaking, student outcomes at ESI have been poor for a very long time. However, the current regulatory construct was not stringent enough to create clear recourse mechanisms for the company. ESI never violated 90/10 and was successful in managing down its 3-year cohort default rates through OPEID gerrymandering and the widespread use of deferment and forbearance. The simple fact that ESI never violated 90/10 or exceeded maximum 3-year CDR levels speaks to the inadequacies of those metrics as an oversight rubric for higher education, but it also should be noted that the company went to great steps to avoid recourse from those rules and the Department of Education’s enacted Gainful Employment rule. Below we discuss some of the schemes that ESI employed over the past 5-6 years to avoid potential violations of the 90/10 rule, 3-year

CDR thresholds, and sustain minimum financial responsibility ratios (at least for a brief period of time). On some level, you have to tip your hat to ESI management. They showed remarkable guile in avoiding regulatory recourse for a long period of time even as their business and educational outcomes deteriorated. Unfortunately, management's schemes only painted ESI into a tighter and tighter corner from which the company could never emerge. Here are some of the regulatory avoidance schemes ESI employed over the past 5-6 years. In many cases, ESI was the first, if not the only company to employ these measures:

- **Gouged on military/department of defense funding.** ESI was certainly not alone in pursuing this strategy, but they were one of the earliest adopters. As you can see from the chart below, ESI's revenues from military and department of defense higher education programs effectively tripled in a 3-year period. As you know, those funds are not considered federal dollars for the purposes of the 90/10 calculation.



- **OPEID "gerrymandering".** Prior to 2010, ESI had 30 OPEID institutions for federal financial aid purposes (the rest of its 130+ campuses were considered branches of those 30). Quietly in 2010 the company consolidated its 30 OPEID institutions into 4, then eventually 2. Why would the company do this? Several of its OPEID institutions were at risk of exceeding the 30% threshold for 3-year cohort default rates. ESI chose to consolidate OPEIDS in advance of the transition to the 3-year CDR standard for compliance purposes. As far as we know, ESI was the first to employ this strategy among publicly traded for-profit postsecondary

- education companies. The company's average 3-year cohort default rate in 2010 was 28.5%, which suggests many campuses could have been sanctioned to some degree if the company hadn't pursued OPEID gerrymandering.
- **Changed credit hours/course to better meet the Gainful Employment rule.** When the Department of Education introduced its Gainful Employment rule five years ago, many for-profit education companies were left "scrambling" due to the low actual repayment rate on federal student loans for those students, modest starting salaries for graduates, and high program cost. ESI certainly fell into this bucket. As an initial solution to Gainful Employment compliance, ESI simply reduced the total number of credit hours required to obtain an associate's degree and increased the number of credit hours per class from 4 to 4.5. This allowed the company to access more federal financial aid sooner in a student's academic career (federal financial aid eligibility is determined based on credit hours, not physical time in school). Through these seemingly modest changes ESI was able to slightly reduce total program cost and increase access to Pell Grants for its students (resulting in lower borrowing), without ever addressing academic quality or outcomes – the desired intention of Gainful Employment.
  - **Rolled out the Opportunity Scholarship.** On the surface, there's nothing wrong with ESI's Opportunity scholarship program which was rolled out in 2H13. The Opportunity Scholarship program reduced program cost to ESI students that stayed in school. Rather than adopt a wholesale tuition price reduction, which almost certainly would have helped the company's lead flow and student start trends, the company chose to offer scholarships to students on a retroactive basis. **Keeping list price tuition at \$493/credit hour (take a moment to digest that), enabled the company to maximize revenues from students that drop out in the first term.** Additionally, the Opportunity Scholarship program enabled the company to more accurately manage student debt burdens based on the amount of Pell Grant and federal student loans received. In many cases, the Opportunity Scholarship was used to simply eliminate a receivable that the student owed to ESI.
  - **Introduced the PEAKS program.** To this day, we have never encountered a more clandestine capital markets instrument than ESI's PEAKS program. The company was purposefully vague about the details of the structure when it was introduced for what are now obvious reasons. PEAKS achieved three critical goals for ESI: reduced bad-debt expense, improved free cash flow, and perhaps most importantly reduced the company's 90/10 exposure. It is remarkable that PEAKS was ever granted "off balance sheet" treatment, given that ESI was the ultimate guarantor of principal and interest payments to the senior note holders.
  - **ESI resists taking accruals for PEAKS or bringing it "on balance sheet.** In 2012 the Access Group, the equity holder in the PEAKS trust wrote down their investment to ZERO. This equity portion of the PEAKS trust was sold for \$1,000 even though ESI management attempted to convince the SEC that it had as much as \$100MM+ in value. Comical.

Presumably, when the Access Group wrote down the value of its equity holdings ESI should have been forced to consolidate the PEAKS trust on balance sheet. There were no other entities with financial exposure to the trust at that time. That did not happen. Bringing the trust on balance sheet could have impacted how those funds were treated for 90/10 and ESI's financial responsibility ratios at that time.

- **As early as 4Q12, ESI started to build accruals for PEAKS.** Despite taking accruals for PEAKS payments and losses on the company's subordinated notes holding in the trust, the company still did not bring the PEAKS trust on balance sheet.
- **Made "Payments on behalf of borrowers"**. In the annals of our work on the for-profit education space, the "payments on behalf of borrowers" scheme will go down as one of our favorites. In effect, ESI made payments for students on their PEAKS student loans starting in 3Q13 so the company wouldn't have to recapitalize the trust (and presumably bring it on balance sheet). The PEAKS senior note holders were upset by the company's decision to try to circumvent their financial obligations through the payments on behalf of borrowers and eventually compelled the company to make accelerated payments to the trust. Amazingly, full consolidation of PEAKS did not occur until a year later.
- **Launched a charter school.** In March 2013, ESI launched the Early Career Academy in an effort to drum up more "10% money" for the purposes of 90/10 compliance. At that time (and still to do this day) there were proposals to include military and Department of Defense funding as federal sources as far as the 90/10 calculation is concerned. ESI would have great difficulty complying with a revised 90/10 standard reflecting those changes. As a result, the company pursued a charter school initiative. Charter schools are a difficult business to operate at a profit, so the motivation here was transparent – 90/10 compliance. The initiative did not get very far.

### **Student Outcomes at ESI Were Terrible**

It is amazing that despite all of the political scrutiny and media focus; investors, students, and taxpayers still do not have real transparency on the outcomes at most higher education institutions, particularly proprietary schools. The cohort default rate, in theory the federal barometer of outcomes only informs us about an institution's ability to compel its former students to pursue deferment or forbearance. We know that outcomes at ESI were very poor. Presumably the management team would argue that these results needs to be normalized for the target student demographic. **Should the Department of Education idly standby when an institution generates 95% of revenues from federal sources, struggles with cash flow and the ability to meet debt payments, flaunts regulatory compliance measures, spends the minimum on educational investment, and has 70-80% default rates? .**

Here's what we know about ESI's student outcomes:

- **The "pain funnel"** – Do you remember this from the Harkin exhibits? In order to understand the type of students ESI targeted and why outcomes might have been less than desirable, we think

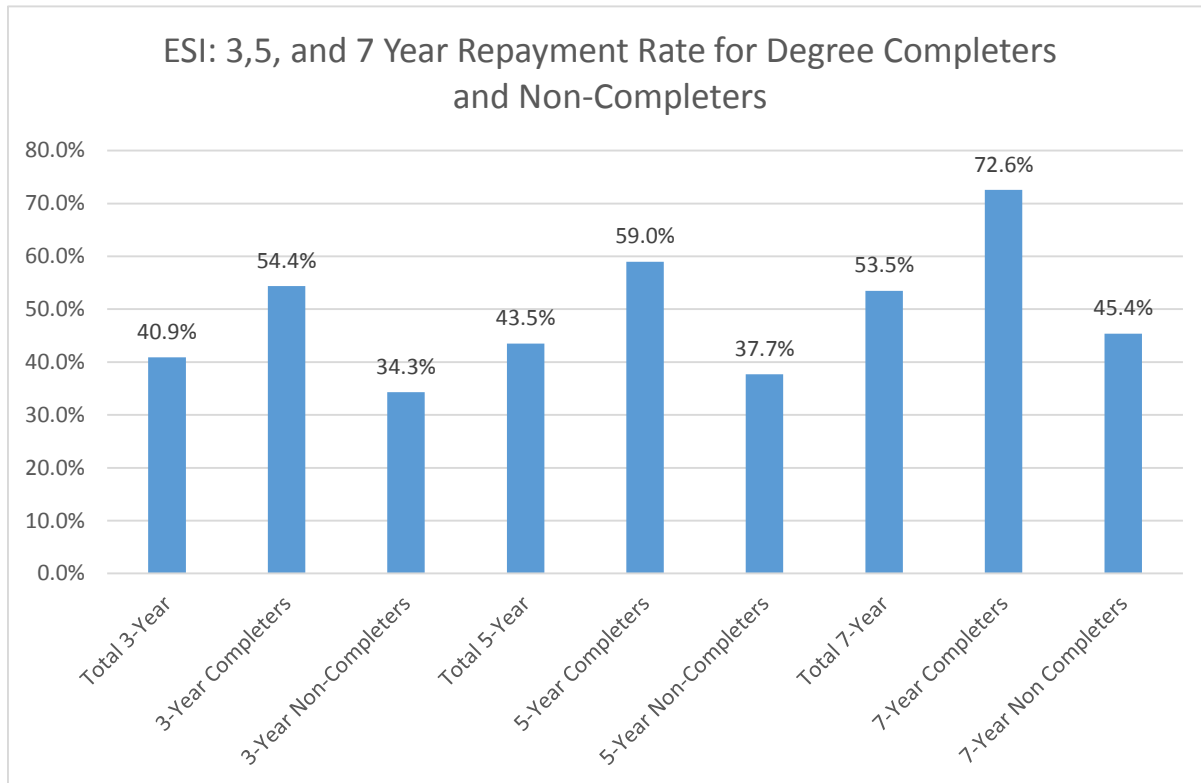
it's important to look at the top of the lead funnel. Enrollment counselors at ESI were trained to ask 8 questions which would ideally illicit a clear picture on four levels of "pain" a potential student was having. This sequence of queries was ultimately supposed to yield the following question: "Does the prospect have enough pain to qualify for the next step?" Obviously this is a different type of recruiting process and one that could result in a different type of student that perhaps under other circumstances would not be enrolled in a high cost higher education program.

- **Default rates on the 2007 Sallie Mae Program were likely 65-70%.** In 2007, ESI entered into a recourse loan arrangement with Sallie Mae. A \$180MM portfolio of private loans were purchased at a discount by Sallie Mae presumably at a 20-30% haircut to face value. ESI eventually was forced (through a lawsuit) to make \$46MM in recourse payments to Sallie Mae. Irrespective of whether Sallie Mae was in a first loss position or if losses were shared ratably (50/50), it seems apparent that cumulative losses on the loan program were in the 65-70% range. Presumably ESI knew about the poor performance of the Sallie Mae loan portfolio when the PEAKS funds were being disbursed, which makes its more questionable as to why the company didn't take accruals on its potential guarantee obligations sooner.
- **Repayment rates for students attending ITT Tech were simply abysmal.** When the Department of Education initially proposed its Gainful Employment rule, it provided the public with data on the 4-year repayment rate at for-profit postsecondary education institutions. To clarify, the repayment rate represents the percentage of students whose principal balance on their loans has declined by at least \$1 and excludes those borrowers who have already defaulted. When the data was first released for FY09, 77 of ESI's institutions had a repayment rate that was below 35% over 4-years. Approximately 10-days ago, the Department of Education released new data on institutional repayment rates through the end of fiscal FY15 (period ending 6/30/15). The data includes the repayment rate for students that completed their degree program and those that did not on a 3, 5, and 7-year basis. **It is important to emphasize that the repayment rate calculation excludes those students that have already defaulted. In the case of ESI, their most recent 3-year cohort default rate was 18.8%.**

As the chart below outlines, ESI's repayment rate overall was 40.9%, 43.5%, and 53.5% on a 3, 5, and 7 year basis. This is simply calculated as the percentage of borrowers whose principal balance has been reduced since origination. It does not capture the magnitude of payment. Perhaps more alarming, the repayment rates for students that graduated from ITT Tech (completers) are the lowest among the large remaining publicly traded for-profit postsecondary education companies. Said another way, even when an ideal outcome was achieved (graduation), ITT Tech students are still struggling to make any sort of payments on their student loans.

There is a widely held view that the government makes money on student loan defaults. We have always questioned the merits of that logic given what we know about the performance of

private student loan portfolios from similar cohorts. We would point to this latest data from the Department of Education as further evidence that the taxpayer losses on student loans are higher than previously thought. Only 53.5% of borrowers that attended ITT Tech had reduced their principal balance over the past 7-years.



- **The default rate on the PEAKS student loans has likely surpassed 80%.** Do you remember when ESI assured investors that losses on the PEAKS private student loans would be minimal because they were issued to second year students at ITT Tech? In the narrative around the PEAKS losses it appears that particular element of the structure has been forgotten. As it turned out the progression of the borrowers in their academic career at ITT Tech did not have a favorable impact on credit outcomes. The last time that ESI publicly commented on expected default rates for PEAKS loan, management was estimating a range of 63-65%. Based on the magnitude of additional payments was forced to make to bondholders over the past two years, we think it is reasonable to assume the default rate on those loans has reached 80-90%. ESI management to this day would like investors to believe that the primary reason that the astronomical default rates on PEAKS student loans was a function of “servicing issues”.
- **NCLEX pass rates were as low as 20% at some Breckinridge School of Nursing locations.** In 2015, more than 157,000 first time test takers took the NCLEX licensing exam, more than 133,000 passed. That’s a pass rate of roughly 84%. ESI’s Breckinridge School of Nursing locations frequently had NCLEX pass rates in a range of 20-70%, well below the national

average. Several states were forced to revoke ESI's license to offer nursing programs or suspend new enrollments as a result of the poor outcomes.

- **For almost six consecutive years, student persistence declined on a YOY basis.** In 20 of the last 24 quarters, persistence at ESI declined on a YOY basis. From 2010-2012, one could make the argument that the decline in persistence was a function of larger graduating classes. However, after that period the size of the company's graduating class in any given quarter was likely a tailwind for student persistence. We can only attribute the decline in student persistence over the past 3-4 years to the reduced investment in educational services.
- **ESI eliminated the Wunderlich entrance examination in 1Q13 in an effort to prop up student starts.** To be clear, the company never announced the change in its entrance requirements but it was likely the sole reason the company was able to generate positive start growth in 2013. However, the changes in entrance requirements did not come without a cost. A reduction in student quality weighed heavily on the company's persistence rates and regulatory risk profile.

### **ESI Management Would Like You to Believe Scrutiny from Regulators, Oversight Agencies, and Accreditors Was All a Storm in a Teacup**

Quick question: do you know what the "Management Objective" for 2015 with the highest weighting for ESI executives was to determine short term compensation/bonuses? At the top the list with a 20% weighting from ESI's 2016 proxy statement:

*"Resolve certain outstanding legal and regulatory matters involving the company."*

If you're wondering how that worked out for management, all named executives at ESI received a bonus equal to 50-100% of their annual salary for 2015. Factually speaking, ESI has yet to lose a court case largely because the company has successfully settled or deferred trial dates. Federal agencies, former students, and state agencies have all taken action against the company in some form. What would lead anyone to believe that the deluge of "allegations" is merely a storm in a teacup? The diversity, magnitude, and frequency of inquiries from oversight agencies certainly would compel one to question the veracity of the company's statements on student outcomes, regulatory compliance, and accounting practices. We think it's important to quickly review the long list of entities that have taken action against ESI over the past 4-5 years.

- **2Q10** – The SEC starts to raise questions about the disclosures and accounting treatment of the PEAKS trust
- **1H11** – Senator Harkin begins to hold hearings about the for-profit postsecondary education sector
- **2Q11** – Sallie Mae sues ESI to obtain payments related to the 2007 student loan program
- **2Q12** – ESI receives a civil investigative demand from the CFPB
- **4Q12** – ESI receives a civil investigative demand from the Massachusetts Attorney General
- **1Q13** – The SEC issues a subpoena to ESI demanding documents related to the PEAKS trust



- **1Q13** – ESI settles with Sallie Mae and agrees to pay \$46MM as a result of the company’s recourse loan arrangement
- **4Q13** – ESI announces that Florida, Pennsylvania, Tennessee, and West Virginia have found that the company has violated the financial standards provisions for higher education institutions in those states
- **1Q14** – the CFPB files a formal lawsuit against the company
- **1Q14** – New Mexico AG files suit against the company for unfair business practices
- **2Q14** – ESI finally consolidates PEAKS on its balance sheet
- **2H14** – 15 state AG’s issue subpoenas or civil investigative demands to the company
- **3Q14** – ESI receives a Wells Notice from the SEC
- **3Q14** – The Dept. of Education places ESI on a form of Heightened Cash Monitoring status which required the company to post a letter of credit equal to 10% of federal financial aid disbursed in the prior fiscal year
- **3Q14** – ED determines ESI’s institutions are not “financially responsible”
- **4Q14** – Dept. of Ed. rejects ESI’s application to offer four new degree programs
- **4Q14** – ESI gets a \$100MM term loan from Cerberus as a “lender of last resort”
- **1Q15** – Dept. of Ed. rejects ESI’s application of offer two new degree programs at Daniel Webster
- **2Q15** – the SEC formally files suit against ESI
- **2Q15** – The Dept. of Education establishes monthly reporting requirements for ESI (enrollments and cash flow)
- **2Q15** – CalVet elects to pull benefits for ESI students (the company sues to maintain benefits for its students)
- **3Q15** – After an audit of federal financial aid disbursements, the Department of Education identifies glaring deficiencies in the company’s administration of Title IV funds.
- **2Q15** – NEASC issues a show cause order for Daniel Webster College
- **3Q15** – The Department of Justice launches an investigation into the company
- **4Q15** – Dept. of Education places ESI on a form of delayed disbursement
- **2Q16** – ACICS places ESI on show cause status
- **2Q16** – Dept. of Education requests a larger letter of Credit for ESI (roughly \$40-\$45MM)
- **3Q16** – Dept. of Education revokes access to federal financial aid
- **2013-Present** – ESI does not have adequate internal control over financial reporting
- **2013-Present** – ESI management consistently understates/underestimates the magnitude of necessary guarantee payments for PEAKS and the 2009 CUSO
- **2009 – Present** – A steady stream of former student, former employee lawsuits and securities class action cases are filed against ESI

As you can see, the Department of Education’s action against the company did not occur without “due course”. From our perspective, the Dept. of Education was forced to act when the company elected to

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slash its educational services spending to unprecedented levels at a time when the company's cash balances were dwindling. The Department of Education was certainly not alone in its scrutiny of the company and it would be hard to classify everything as "unproven allegations".

**Ask not What It Will Cost Taxpayers to Shut Down ESI, but What it HAS Cost the Public for Years**

After reading our recount of the events that led to ESI's bankruptcy, we hope that it will become self-evident that the Dept. of Education had no choice but to take action against ESI to protect taxpayers. We only wish it had happened sooner.

**As always, please act accordingly...**

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