Capella's Cobweb: An Andragogical Analysis of The Digital Diploma Mill Market

Ticker: CPLA	Current Price: $67.48
Action: SHORT	Target Price: $44.50
Timeframe: 1-2 years	Market Value: $815M
Target Allocation: 5-10%	Instrument: LONG PUTS
Catalyst: Enrollment Distribution, Regulatory Changes, Competitive Weaknesses	

Profile

Capella Education Company, through its subsidiaries, operates as an online postsecondary education services company primarily in the United States. It offers various doctoral, master's, and bachelor's programs primarily for the public service leadership, nursing and health sciences, behavioral health and human services, business management and informational technology, and education markets; and online distance learning services, including degree-entry programs and doctoral level programs in various disciplines. As of FY14, the company offered approximately 1,740 online courses and 43 academic programs with 145 specializations to approximately 36,000 learners. Capella Education Company was founded in 1991 and is headquartered in Minneapolis, Minnesota. In addition to Capella University, the corporation also consists of three wholly owned subsidiaries:

- **Resource Development International** (RDI) is an independent provider of United Kingdom (UK) university distance learning qualifications that markets, develops, and delivers these programs worldwide via its offices and partners across Asia, North America, Africa and Europe.
- **Sophia Learning, LLC** (Sophia) is a social teaching and learning platform that integrates education with technology.
- **Capella Learning Solutions** (CLS) is a subsidiary created in 2013 that provides online training solutions and services to corporate partners, which are delivered through Capella's online learning platform.

Overview

In the winter of 2014 our firm began researching the intricacies of the student-debt problem; namely, the for-profit colleges that contributed to it. In January, we released a thesis on the Apollo Group (NYSE: APOL) titled *Educated Risk: A Thematic Analysis of The Apollo Education Group*.[1] On March 24th, the stock plummeted 30 percent and investors witnessed their first glimpse of the for-profit education disaster since 2010. Afterwards, investors began inquiring about the framework of the "higher quality" programs; Capella was at the top of the list. What most failed to realize was their answer laid right in front of them: the title. The problems that inevitably preyed on Apollo was part of an overall theme hitting the industry, it was, and continues to be, systemic.

[1] A copy of this research can be found on Taylor Mann's (Founder of Pine Capital) profile page on Harvest (www.hvst.com). The Harvest Exchange is a financial discovery platform that offers a network of access to direct and transparent investment expertise and products.

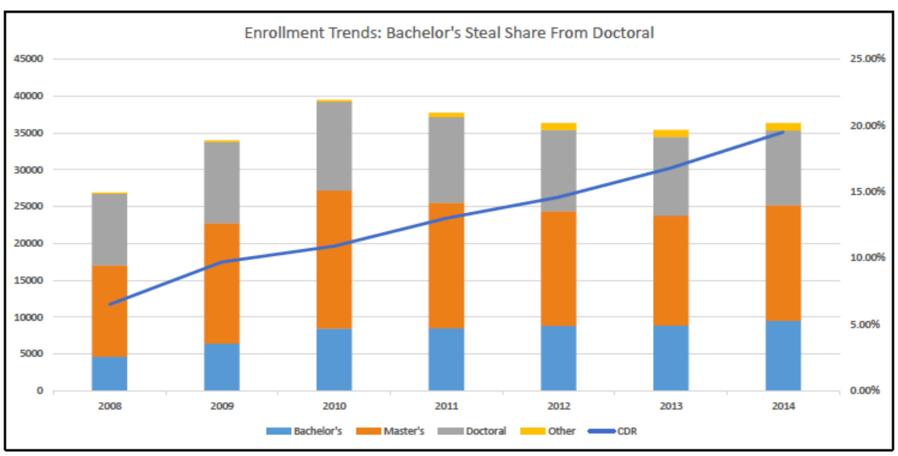
Previously, the sole focus on postgraduate education is what separated Capella from its morally bankrupt competitors. Over the years, in the face of crimpling enrollment pressure, the management team used this competitive advantage as leverage to siphon the few funds that remained in the accounts of those who trusted them the most: doctoral students. Thousands of students, often unheard of, have complained and even organized into groups regarding the manipulation and unethical practices of Capella; specifically, the prolonging of graduate programs, the inability to obtain state licenses, and most importantly, the unwarranted overcharging.

Enrollment Distribution

Despite being a relatively unattractive metric, the economics behind enrollment distribution tend to be one of the most accurate predicative indicators in educational service analysis. In fact, this figure is typically one of the first metrics that is illustrated inside each annual report. The significance behind this measurement lies in the derivatives: revenue per learner, cohort-default rates, and operating margins. The logic behind the derivative's sensitivity to a change in enrollment distribution stems from the economics of education: the lower the degree, the more expensive and less profitable educating that student becomes.

For example, the University of Phoenix had to proactively deter prospective associate degree candidates away from the university because the larger associate volume began to increase their cohort-default rates as well as increase the federal share of income close to the 90 percent threshold; this is because the vast majority of undergraduates drop-out within the first several months and use FFELP loans to finance their education.

In regards to Capella University, over the last decade we have seen a precipitous increase in the share of undergraduate students; in turn, their cohort-default rate has doubled. If this trend continues, the negative stigma that has attached itself to so many of Capella's competitors will begin to attach itself to this university. To exacerbate this problem further, this stigma will be followed by the following: an increase in bad debt expense, higher cost of new enrollment, reduced margins, and increase in Title IV funding.



As illustrated in the graph above, undergraduate students contributed to over half of the enrollment increase since 2008. Interestingly, the cohort-default rate is almost perfectly correlated with the undergraduate enrollment figure ("Bachelor's"). As the number of borrowers entering repayment increases, the cohort-default rate will rise exponentially: the rate at which the cohort-default rate increases is increasing year-over-year. As a self-proclaimed "graduate institution" their business model relies heavily on recurring income and high retention rates; based on our calculations, that reliance is transforming into a virus.

Post-research, this enrollment trend is rather unsurprising; the majority of the doctoral programs fail to ever receive accreditation. For example, Capella University has an entire college focused on the area of psychology; however, none of the programs are even accredited by the American Psychological Association (APA).[2] The APA license refusal is due to following: insufficient residency hours, failure to satisfy coursework, and the lack of a state-approved clinical program. The APA focuses on doctoral graduate programs; namely, in professional programs (i.e., PhD or PsyD).

In regards to the undergraduate programs, if we said that the retention rate was abysmal it would be a dramatic understatement. According to the Department of Education, the retention rates for part-time students pursuing a bachelor's degree were 21 percent during the 2012-13 school year.[3] During that same time period, the average retention rate amongst part-time undergraduate students at for-profit universities was 39.4 percent; almost double that of Capella. [4]

Structural Inefficiencies

In one of the best exemplifications of incompetency, the management team spent close to $500 million in marketing over the past five years; during this same time period, enrollment declined nearly 10 percent. The for-profit college model is actually akin to the diamond industry: spend the majority of revenue on marketing and promotion to convince the general public that there is a demand for their useless product. At almost $3,000 per student, Capella spends double the industry average on marketing.[5] To exacerbate this problem, this expense will be forced to increase as their retention rate falls and enrollment declines; we estimate that this figure will need to revert to Pre-Recession numbers ($4,500 per-student or $130 million total) to reeducate prospective students and increase enrollment.

As evidenced across the industry, there is a direct inverse correlation between cohort-default rates and enrollment: when cohort-default rates rise enrollment decreases. In 2009, there was a 20-point spread between the cohort-default rate between the University of Phoenix and Capella University; as portrayed in the chart above (See – Enrollment Trends: Bachelor's Steal Share From Doctoral) our model predicts that when 2014 rates are released, the spread will be zero. If the correlation persists, enrollment will decline at 5 percent per-year over the next three years; the company will be hemorrhaging over $100 million per year by 2017 due to this structural inefficiency ($65M loss on revenue and $35M gain on advisory/marketing services).

[2] The APA Commission (APA-CoA) is recognized by both the secretary of the U.S. Department of Education and the Council for Higher Education Accreditation, as the national accrediting authority for professional education training in psychology.
[3] Virtually all-undergrad students at Capella University are considered part-time.
[4] U.S. Department of Education, National Center for Education Statistics (2014). *The Condition of Education 2014* (NCES 2014-083), Institutional Retention and Graduation Rates for Undergraduate Students.
[5] These figures are for marketing per-student (MPS = Marketing Expense / Student Total as of December 31st of the prior year).

To combat this problem, Capella reverted to industry standards: make profitable classes mandatory, increase complexity in withdraw procedures, and provide greater incentives to entice prospective students. Here is a complaint from a former PsyD student:

> "…We were near the end of a semester and I believe Capella purposely delayed the processing in order to get me to pay for another dissertation course room. The dissertation course room is a chat room for learners to discuss the issues. It serves no academic purpose yet it costs over $2000.00. Originally Capella said we had to take it four times, I have now taken it six times at a cost of almost $18,000 and after talking to advising yesterday I get the distinct impression they are pushing for me to take it again."

If you are unfamiliar with the work by the Consumer Finance Protection Bureau (CFPB), this is exactly the type of manipulation they aim to prevent. Remember, the student in the complaint above is in a psychology program that is not even accredited by the American Psychological Association. Moving forward, as complaints such as this one accumulate and become commonplace, the CFPB as well as other agencies will begin to look closer at the unsound framework that this company operates on.

Competition

Although some disagree, the sole contributor to the success of the for-profit college model seen in the last decade was due to their ability adapt faster than non-profit universities to educational technologies. The educational technology sector has experienced rapid growth in the past several years; notably, due to the growing demand for postgraduate education and the ongoing shift in consumer preferences. This consumer transition is organic, as we further integrate technology in our learning habits; it is only natural that we become less dependent on our geographic location and more dependent on the way in which we learn.

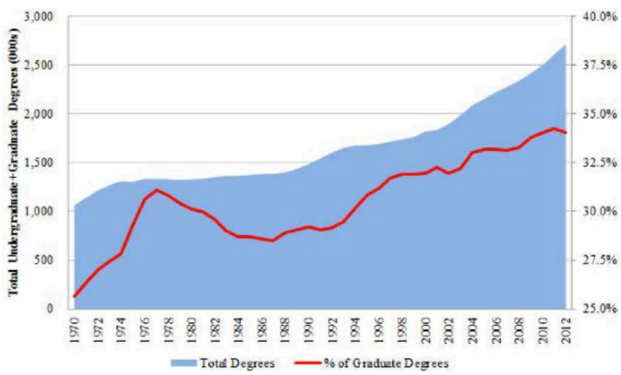
In regards to the rapid change in consumer preferences, the Darwinian nature in Corporate America took hold as the for-profit education industry stepped in to fill the growing demand for on-line education that non-profits were unable to adapt to. Fortunately, a company by the name of 2U (TWOU) has stepped in to bring non-profits up to speed; inevitably ending the competitive advantage held by the for-profit education sector. Everything desired by Capella is innate in non-profits: industry connections via alumni, brand awareness via sports and research, and lower tuition rates via government subsidies.

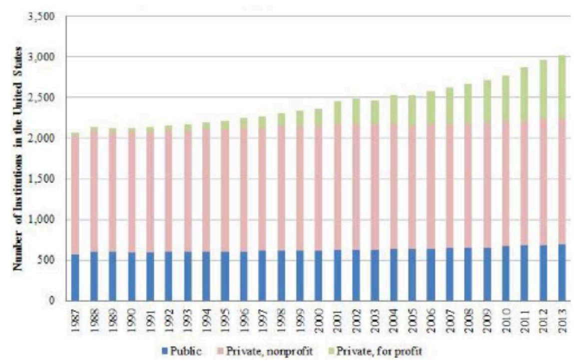
In addition to 2U, we are seeing an overwhelming increase in Massive Open Online Course (MOOC) offerings; mostly, from the country's top universities: Harvard, MIT, Yale, and Stanford. Although these courses currently do not offer credit, they do offer certificates and forms proving that students successfully completed the course. As the tuition continues to inflate relative to income, we will see more students apt for less costly learning environments. For the first time in decades, postsecondary education will become elastic.

Prior to the non-profit reconnaissance, on-line for-profit universities could collude and charge exorbitant prices. Now, institutions such as Southern New Hampshire University (a non-profit university) are offering postgraduate courses at competitive rates; due to lower taxes and government subsidies, for-profit corporation cannot afford to lower tuition.

In addition to non-profit institutions and start-ups, other for-profit institutions are aiming to replicate Capella's success and have begun making the appropriate investments to bring this strategy to life. This, among other reasons, is why we believe the student mix is being reallocated dramatically. As evidenced over the last ten years, people are taking more time than ever to enter the work force for two reasons: 1) People are taking longer to graduate, and 2) More people are pursuing more post-graduate degrees.

The success of post-graduate programs, for the most part, is due to a misunderstanding of marginal utility, federal loopholes, access to credit, and lack of career alternatives. Over next several years, we predict that Capella will continue to lose doctoral enrollment for several reasons: increased industry competition, idiosyncratic problems, and a saturated employment market for lower-tier post-graduate degree holders. Below are two charts representing both the growth of graduate degrees as well as the number of institutions supplying them:





As illustrated by the graph on the left, virtually all of the growth stems from for-profit colleges since 2008; during this same time period, percentage of doctoral students at Capella has dropped from 36.2 percent to 27.8 percent. Capella's quality is not derived from their instruction; in fact, it is due to their student mix. Previously, their typical cohorts consisted of forty-year old graduate students; the median salary does not reflect the twenty-years of work experience most students carry and the fact that cohort-default rate does not account for those who continue to pursue doctoral work, which many at Capella do.

With both cheaper and higher-quality postgraduate institutions entering the online space, as well as, a saturated market for non-STEM graduate degree holders, we believe that distribution trends will continue for Capella; in turn, this will directly impact operating margins and cash flows. We believe that the increased competition will impact the bottom-line in the near-term for the following reasons:

- Competition will make it challenging to enroll students who will succeed in the programs, this will impact enrollment and put downward pressure on tuition rates.
- Capella will have to partner with employers to stay competitive; employers are now more likely to partner with non-profit universities.
- It will take longer and be more costly to invest in new programs and adapt to industry trends.

Accounting Changes

In 2010, Senator Tom Harkin and the U.S. Senate Committee on Health, Education, Labor, and Pensions (HELP) released a paper titled "For Profit Higher Education: The Failure to Safeguard the Federal Investment and Ensure Student Success". The paper set a precedent for the industry, and scolded Capella Education for their absurd spending on marketing. During 2009, the year analyzed for the report, the company spent $100 million on marketing; 30 percent of revenue. To make this worse, this same year, 80 percent of the revenue was derived from the Department of Education and the Department of Defense.[6]Naturally, instead of allocating a higher percentage of funds to instruction, Capella invented a new category for accounting purposes: Admissions Advisory.

The deceit behind this category lies in the ambiguity behind *admissions*; virtually all for-profit programs are open enrollment. By using this method, they were able to reclassify the marketing expenses in 2010 to $86 million from $120 million; this recalculation made the marketing per-student figure drop by 29 percent, from $3050 per-student to $2178 per-student. According to corporate documents, *marketing and promotional expenses* are focused on improving conversion rates and new enrollment growth. With open enrollment, admission advisers are this industry's term for sales force; here is an excerpt from the HELP committee's research regarding a complaint from their "sales force":

> "My husband was looking into online universities and one of the ones he signed up for (for more information) was Capella University. The next day… personnel from their sales department began calling my cell phone. I told them to remove my number from their database. They continued to call, getting the same response from me, every hour for about four hours… The calls did not stop. At one point, I even had one lady try to argue with me that I told her not to call again!"

To be clear, we are not insinuating that recognizing a profit is unlawful; however, if that was solely the case, why the accounting changes? Complaints are often bimodal; typically, only people with extreme feelings are willing to take the time to post a complaint or good review. It's difficult to speculate on the compliments, because they are never detailed like the complaints: the good reviews are normally limited to, "this is a great school" and that's the end of it. However, for the complaints, the vast majority pertains to the same exact situations: prolonging graduation unjustifiably and overbilling.

Valuation

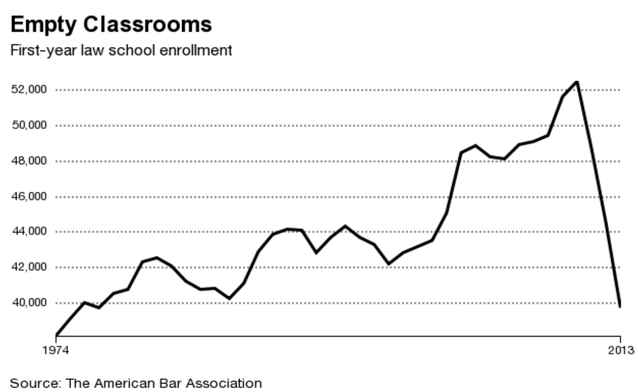
For reasons unbeknownst to any logical investor, Capella sports a trailing PE Ratio almost twice that of its peers average (22.01 vs. 12.71). This overhyped valuation stems from syllogism: any increase in enrollment is good, Capella increased enrollment, and therefore, Capella is good. Although the syllogism is logically valid, it is far from financially valid. The premise "any increase in enrollment is good" is invariably false. For example, if we look back to FY09 when distribution mix began to change, Capella experienced $135 million in instruction and services; last year, with only three thousand more students, instruction and services was $185 million. As a percentage, a 9 percent increase in enrollment translated to a 37 percent increase in instruction and services expenses.

[6] The Department of Defense pays for active duty military and veterans' tuition via the Post 9/11 GI Bill.

Doubtful accounts are a large contributor to this increase; this is one of the many problems that stem from lower quality students and a suboptimal distribution mix. In the near-term, two contributors will lead a dividend cut: a decrease in profit per-student and a demand for an investment in technology and other resources (e.g., adjunct professors to assist students in the dissertation process).

The premium currently placed on this stock is irrational; despite having practically the same enrollment, shares are up 150 percent since their 2012 low ($26.52). During this time period, FCF per share is down 25 percent, and return on both equity and assets have fallen as well. Short-term revenue gains stem mostly from an increase in tuition rate; tuition increases are not a sustainable source of revenue. As stated earlier, the company will have to grow enrollment just to compensate for the change distribution mix. The company expects enrollment to increase about 4 percent this year, about twice the increase from the year prior; the company also expects revenues to increase by the same percentage. Executives and analyst across the industry predict that last year was the bottom for enrollment and the turn-around has since begun. Put simply: they're wrong.

In addition to our enrollment premise, not only does the distribution matter, but the quality of students that the company enrolls matters as well. The causality of this trend is akin to the law school bubble during the same period: with no career alternative, students looked for opportunities that could be derived from the only thing they were comfortable with: more school. The underlying fundamental problem is that accreditation agencies allowed law schools to pop up everywhere, and others to increase enrollment. Eventually, this not only saturated the industry; but the students who were actually qualified to enter law school never went because they no longer saw the economic benefits. Here is chart of the bubble:



So, why is this relevant to Capella? This university operates under the same underlying premise that law schools did: graduate education in high-demand careers will always provide economic benefits to the degree holder. The same exact scenario will unfold in the medical field: due to the high demand, for-profit colleges are looking to feel the gap for the thousands of people who were denied acceptance to the higher quality medical programs. In turn, the market will be saturated, regulations and prerequisites will increase, and students whom graduated will have a debt loan that could only be afforded from salaries years' prior.

Enrollment has increased in two fields for Capella: undergraduate business and graduate degrees in counseling. Like Strayer, Capella will find out that this enrollment uptick is solely temporary. After reporting a decline after the enrollment uptick, the stock has traded down 25 percent. During the temporary enrollment/revenue increase, Strayer was trading at 18x earnings; they now trade below 12x. When Capella experiences the same result, we predict they will trade similarly to Strayer; this will give them a multiple of 14.6 and trade at $44.43 per share. Note: our Discounted Cash Flow Model estimated a fair value of $44.88. We have set a $44.50 price target on this stock, a 33 percent decrease from today's value of $66.50.

Delinquency Rates

Despite accounting for only 11 percent of the federal student loan deficit, for-profit education students accounted for approximately half of defaulted debt. This statistic in its self summarizes the banality of these institutions as well as highlights the lack of any gainful employment. Fittingly, student loan default rates are manipulated and artificially deflated. There are two major contributing factors to this manipulation: 1) a conflict of interest via third-party servicers, and 2) federal loopholes. The default rate is calculated using a denominator of the entire student debt outstanding, however, a large amount of this debt is not in repayment; almost $200 billion of the debt is from students still in school or in grace periods. The chart below illustrates a breakdown of U.S. Student Loan Debt payment status by type:

Breakdown of U.S. Federal Student Financing by Repayment Status, Type (As of June 2014)

	In School	In Grace Period	Repayment	Deferment	Forbearance	Default	Other	Total
Direct (Student Borrower)	$136	$43	$300	$89	$75	$37	$5	$686
# of borrowers (millions)	*7.6*	*1.8*	*12.3*	*3.4*	*2.5*	*2.6*	*0.2*	*30.4*
FFEL (Family Borrower)	$6	$3	$243	$39	$44	$62	$6	$403
# of borrowers (millions)	*0.4*	*0.2*	*12.2*	*2.0*	*1.7*	*4.4*	*0.2*	*21.1*
Total Fed Student Lending	**$142**	**$46**	**$543**	**$128**	**$119**	**$99**	**$11**	**$1,088**
# of borrowers (millions)	*8.0*	*2.0*	*24.5*	*5.4*	*4.2*	*7.0*	*0.4*	*51.5*
% of notional US$Bn	13%	4%	50%	12%	11%	9%	1%	100%

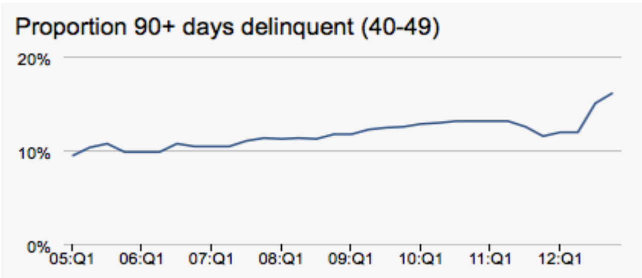
At risk of default

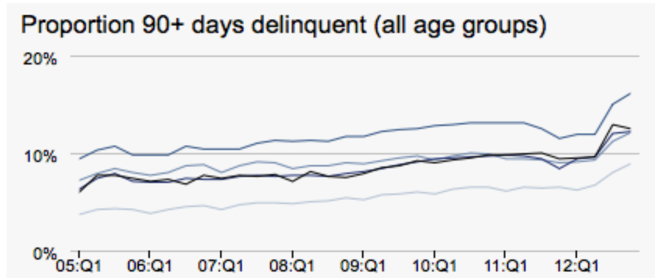
Source: U.S. Department of Education, National Center for Education Statistics

Here is where our two factors become intertwined: for-profit colleges contract third-party servicers (Navient Corp.) to "cure" their cohort-default rate by placing students in forbearance and deferment programs. This "curing" is not only unethical, but inherently fraudulent; student loan servicers contracted by the government receive a bonus for each student they remove from delinquency. Therefore, all the incentive is to place students in deferment and forbearance, despite their financial situation.

If we look at the chart above, we see that there are currently 51.5 million borrowers. Currently, the delinquency rate is calculated using this total; however, 10 million of that total is either in school or in grace period, only the outside of this segment should be calculated. Using this method of calculation, we get 41.5 million borrowers; by adding in forbearance and other to the default rate, the delinquency rate doubles (13.5% to 27.2%).

Moving forward, the average age at this particular university is forty-years old. According to the Federal Reserve Bank of New York, this is one of the worst performing demographics for loan repayments. Beginning in the first quarter of 2012, the proportion of 90+ days delinquent (40-49) was 16.1 percent. Below is an illustration of this data:





Using our calculation methods, the 16.1 percent delinquent rate for this demographic is actually double the estimated amount, or 32.2 percent. Furthermore, as you can imagine, the majority of students in the age group attend for-profit on-line universities. Unfortunately, the toxicity of student debt has yet to reach the precipice. The loophole and incentive problem exacerbates the problem exponentially: both interest and loan payments accumulate while the borrower is in deferment or forbearance, therefore, making it all the more unlikely that the loan will ever be paid back.

Predatory Tactics

As of the FY14, Capella University is one of two front-runners in the for-profit education sector; they are only one of two colleges to actually increase enrollment within the current decade. Obviously, the change in enrollment trend is not due to their superior job-placement rates; this uptick is exclusively derived from preying on undergraduate students; specifically, women and military members. For Capella, women and military members are the ideal candidates: high access to federal loans and in search of an alternative career. Note: Women and Military make up 74 and 14 percent of the student body, respectively.[7] Here is an excerpt from corporate documents regarding their recruiting practices:

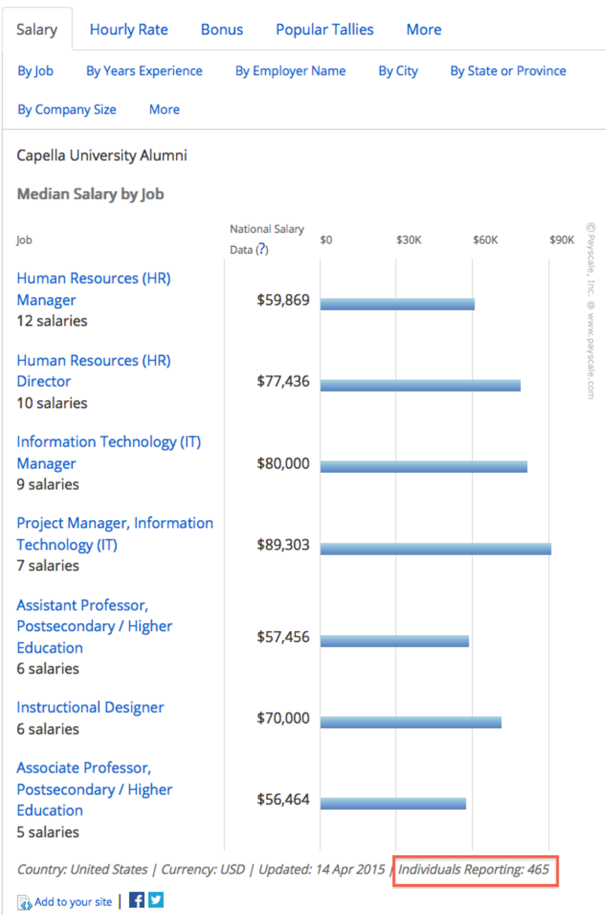
> "A Capella recruiter training presentation entitled 'Sales Framework Overview' provides insight into the sales culture that informs Capella's recruiting practices… The presentation goes on to outline what this sale requires: 'Dig deep into the prospect's needs, goals, motivations, dreams, aspirations, etc. (uncover the "why"). Use this information to position Capella as a solution.' According to this training presentation, a Capella recruiter's job involves 'balancing two roles,' that of a counselor, who is 'good at asking probing questions, getting people to talk, and uncovering needs and motivations,' and that of a salesperson, who is 'good at presenting information in a persuasive way and motivating others to take action.'"

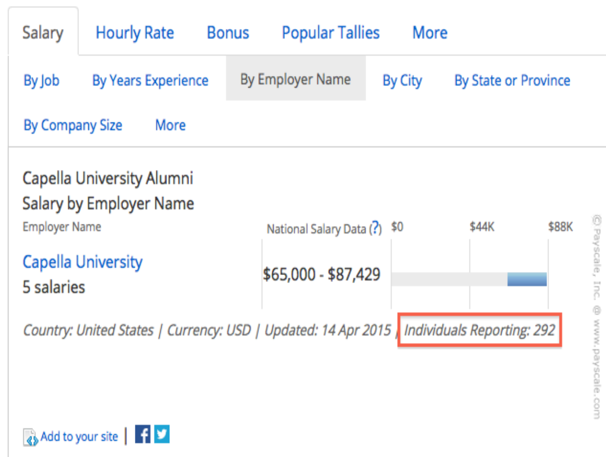
As evidenced in countless investigations, recruiters, or *admission advisers*, often use what is called a "Pain Funnel" to convert prospective students into customers; this strategy uses questions like, "Have you given up trying to fix your financial problem?" Capella is better than the vast majority of for-profit colleges in regards to predatory tactics, however, that does not mean that tactics are not used. It is not unlawful for this university to supply an education that will never produce economic benefits; they are not making students attend the school. Despite this, it is unethical to produce skewed employment data as well as allude that their programs meet the highest standards of accreditation and licensure requirements.

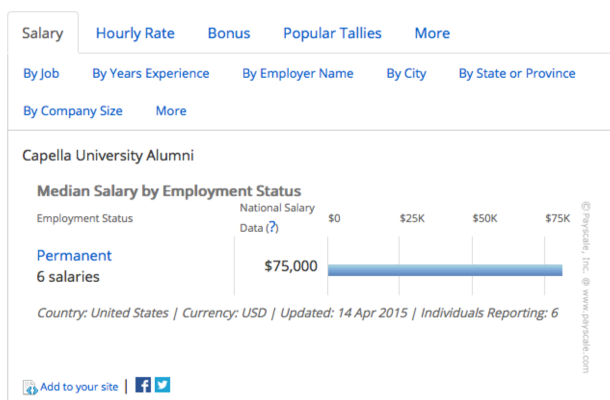
[7] Corporate Presentation "Capella's Strong Position" March 2015.

Skewed Statistics

When it comes to the misuse of statistics, for-profit colleges are right there with yellow journalist and multi-level marketing firms. To say the statistics are skewed would be a drastic understatement; albeit lawful, but unarguably misleading. For prospective students, PayScale is the go-to source for salary data. According to their data, 465 Capella alumnus posted salary data. At first glance, the reported salaries appear to be promising; however, like every other metric from this corporation, the statistics are skewed in their favor. The charts below were taken from the PayScale website, of the 465 salaries posted, 292 stem from one employer: Capella University. Even worse, for the 465 jobs reported, only 6 were permanent.







Although this data is valid, it is unequivocally misleading. We use PayScale data to portray the biasness due to the majority of prospective students turning to these statistics in order to verify the claims made by university recruiters. For one, statistics used by the company and third-party data services only compile college graduates with a job, the minority of the sample group.[8] For example, the university websites touts a $65,347 salary for students graduating with a bachelor's in business administration. In addition to this, they note that difference between graduating with a business degree from Capella University versus their peers is a 61 percent difference.

This salary is higher than the average from the Haas Business School at UC Berkeley.

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[8] Capella Education Corporation uses 2012 U.S. Department of Education gainful employment calculation samples.

Gainful Employment Rule (GER)

On July 1, 2015 the federal regulations regarding the GER will finally come into effect.[9] According to the Department of Education, 840,000 students are currently in programs that would not pass the regulatory criteria – and of those students, 99 percent are in programs at for-profit institutions. The framework of the final regulations has two components: accountability and transparency. The accountability component distinguishes programs that provide affordable training that leads to well-paying jobs from those programs that leave students with poor earnings prospects and high amounts of debt, while the transparency element requires institutions to provide key information for consumers. To illustrate this framework, we have attached a chart from the Department of Education:

Accountability	
Certifications: Institutions must certify that each of their gainful employment programs meet state and federal licensure, certification, and accreditation requirements.	
Metric: To maintain title IV eligibility, gainful employment programs will be required to meet minimum standards for the debt vs earnings of their graduates.	
Pass	Programs whose graduates have annual loan payments less than 8% of total earnings OR less than 20% of discretionary earnings.
Zone	Programs whose graduates have annual loan payments between 8% and 12% of total earnings OR between 20% and 30% of discretionary earnings.
Fail	Programs whose graduates have annual loan payments greater than 12% of total earnings AND greater than 30% of discretionary earnings.
Ineligible	Programs that fail in 2 out of any 3 consecutive years OR are in the zone for 4 consecutive years.
Transparency	
Disclosures: Institutions will be required to make public disclosures regarding the performance and outcomes of their gainful employment programs. The disclosures will include information such as costs, earnings, debt and completion rates.	

According to public records, the average doctoral graduate from Capella University holds approximately $85,000 in student loan debt. Under gainful employment regulations, doctoral students would have to make $90,543 per year just to fall in the direct middle of the "zone"; the student would need to make over $113,179 per year to pass and would need to make below $75,452 to fail. At the 10 percent level, this would correspond to a debt-to-income ratio of 0.9. According to Capella's most recent presentation, the average salary amongst their psychology PhD graduates is $71,660.[10]

[9] The GER uses two test – one that looks at whether former students are in fact paying loans and another that looks at debt-service-to-income ratios to determine whether graduates have sufficient income to enable them to have a reasonable chance of repaying their loans.

[10] This calculation used variables provided by the Department of Education (i.e., Loan term rate should be calculated using a 15 year loan). By using these metrics, we calculated a loan payment of $754.53 per month.

Legislative Risk

As in any highly regulated industry, the ties between Wall Street and Washington are both essential and highly sought after; the education industry is no exception. The typical contributions are there, the most going to John Kline (R-MN); a congressmen within the home state of Capella that is largely funded by for-profit education corporations. To illustrate the importance of this relationship, we can look at an excerpt from H.R. 4870 The Department of Defense Appropriations Act 2015, Sec. 8111/8112:

> ***Sec. 8111.*** *None of the funds made available by this Act to carry out voluntary military education programs may be disbursed or delivered to an institution of higher education (or other postsecondary educational institution) on behalf of a student, or to a student to be used to attend the institution, unless the institution certifies to the Secretary of Defense that it will not use revenues derived from educational assistance funds provided in any form under any Federal law for advertising, marketing or student recruitment activities (other than activities required or specifically authorized by title IV of the Higher Education Act of 1965 or otherwise specified by the Secretary of Defense).*
>
> ***Sec. 8112.***
>
> *(a) Prohibition regarding voluntary military education program assistance.—*
>
> *None of the funds made available by this Act to carry out voluntary military education programs may be disbursed or delivered on behalf of a student to a proprietary institution of higher education (as defined in section 102(b) of the Higher Education Act of 1965 (20 U.S.C. 1002(b))), or to a student to be used to attend such institution, until the institution demonstrates to the Secretary of Defense that the institution derives not less than 10 percent of such institution's revenues from sources other than funds provided under title IV of such Act (20 U.S.C. 1070 et seq.) and funds provided under such voluntary military education programs, as calculated in a manner to be determined by such Secretary and consistent with section 487(d)(1) of such Act.*

The passing of this bill would have indirectly destroyed many for-profit colleges; marketing expenses would be cut dramatically and they would certainly inch closer to the 90/10 thresholds, as 13 percent of their revenue would now be considered federal funding. Of course, John Kline killed this bill several minutes after its release. Typically, corporations that receive government contracts are prohibited from having operating margins of this magnitude; this goes for marketing as percent of revenue as well.

Despite President Obama's stand against for-profit education, he nominated Ted Mitchell to serve as a senior staff member at the Department of Education. Prior to the nomination, Mitchell set on the board of Salmon River Capital, during his tenure at this venture capital firm they helped create Capella University. With heavy military recruiting, Capella is extremely sensitive to regulatory risk in regards to recruiting, the 90/10 rule, and marketing per-student.

With about half of revenue going to marketing and profits, this corporation is highly sensitive to legislative changes.[11] A reduction in marketing as a percent of revenue would seriously harm their new enrollment. In a time of increased transparency and corporate responsibility, spending half of revenues which derive mostly from taxpayer funding on wasteful Internet ads and profits is likely to be perceived as unfavorable when regulators take another look post-gainful employment.

[11] We added Admission Advisers to marketing expenses, as regulators will most likely look at it the same way as we do.

Industry Forecast

On April 8th, Moody's placed 14 tranches in 14 securitizations backed by student loan originated under the FFELP under review for downgrade; these tranches are worth about $3 billion (12 of the 14 securities are sponsored by Navient). The review is due to their view that these bonds may not be fully paid down prior to legal final maturity, resulting in an event of default for these transactions, said Deutsche Bank regarding the matter. As mentioned previously, the downgrade stems from a multitude of factors: higher-than-expected utilization rates of deferral and forbearance, weakness in the job market for new grads, and expanded availability and uptake of income-based repayment plans. To illustrate the toxicity as well as the rate at which these loans are entering delinquency, here is the quarterly service report of SLM Student Loan Trust 2007-2:

		12/31/2014				09/30/2014			
		Wtd Avg Coupon	# Loans	Principal	% of Principal	Wtd Avg Coupon	# Loans	Principal	% of Principal
INTERIM:	IN SCHOOL	2.05%	2,440	$9,746,825.63	0.830%	2.08%	2,832	$11,293,385.75	0.920%
	GRACE	2.10%	886	$3,304,220.34	0.281%	2.05%	1,497	$5,099,120.85	0.416%
	DEFERMENT	2.15%	49,594	$163,243,951.55	13.904%	2.15%	55,739	$185,322,770.78	15.104%
REPAYMENT:	CURRENT	2.69%	207,811	$597,205,753.20	50.864%	2.70%	214,342	$617,429,631.53	50.320%
	31-60 DAYS DELINQUENT	2.72%	15,389	$54,695,762.92	4.658%	2.72%	15,358	$55,583,060.57	4.530%
	61-90 DAYS DELINQUENT	2.74%	10,031	$36,431,326.02	3.103%	2.71%	8,577	$30,760,261.13	2.507%
	91-120 DAYS DELINQUENT	2.75%	7,144	$26,339,306.03	2.243%	2.73%	6,576	$23,501,776.29	1.915%
	> 120 DAYS DELINQUENT	2.77%	17,941	$65,600,964.21	5.587%	2.74%	17,860	$64,652,717.30	5.269%
	FORBEARANCE	2.71%	52,576	$209,521,198.94	17.845%	2.72%	55,154	$223,973,415.07	18.254%
	CLAIMS IN PROCESS	2.62%	2,388	$7,958,140.06	0.678%	2.73%	2,723	$9,293,145.03	0.757%
	AGED CLAIMS REJECTED	2.33%	20	$65,684.87	0.006%	3.03%	26	$103,826.35	0.008%
TOTAL			366,220	$1,174,113,133.77	100.00%		380,684	$1,227,013,110.65	100.00%

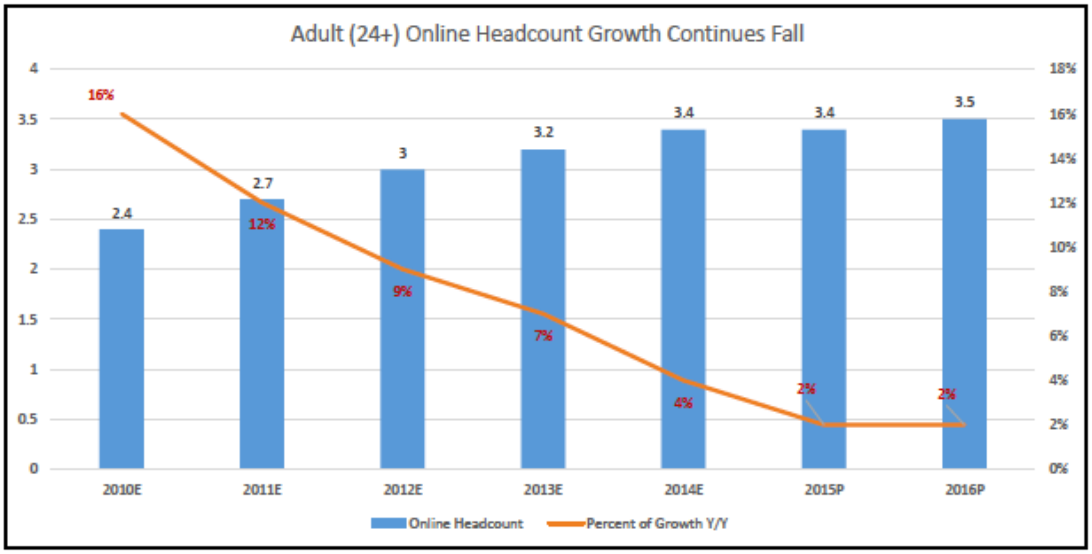
The loans are getting progessively worse

Note, this is not the worst security we've found; the reason we used this exact security is because the sheer size: $1.17 billion. The thing about holes is, when you're in one, stop digging. For-profit colleges and the Department of Education have done just the opposite. The problem is that the majority of the outstanding student loan debt is currently with students that are currently in school or in a grace period. Therefore, the majority of statistics are skewed; as stated earlier, the true default rate is actually double of what many think it is.

The vast majority of for-profit institutions have continually lost enrollment over the past five years; despite an uptick here and there, the trend is powerful and continuing to get worse. Metaphorically, Capella is essentially an apple hanging from the rotting tree of for-profit education; the drought hasn't ended, hell, it's just now beginning.

To further illustrate this dysfunction, the single-best operator in this industry is seriously considering restructuring to become a non-profit institution due to the negative stigma and the incremental tax expenses. "The stigma surrounding the for-profit industry – some of which is deserved, and some not – is real and it is not improving," said Chief Executive Officer Brian Mueller. Such a move would also lift a growing tax burden, Mueller told investors last month. The company's income-tax expense rose 28 percent to $56.2 million last year, according to its annual report. [12]

Political ideologies aside, this is probably the most intelligent statement I have heard from a for-profit college executive. Mueller understands the problem: the stigma, like a virus, is systemic. As illustrated in the chart below, non-traditional student growth among online education providers are forecasted to plateau. Although the hemorrhaging has ceased, declines are expected to continue in this niche.



This stigma that Mueller elaborated on earlier is true: Southern New Hampshire University is on pace to double their enrollment over the next two years. This new hybrid-like institution is gaining momentum, and naturally, has attracted several competitors; namely, Arizona State University. The beauty in this hybrid model is corporate relationships; a partnership that for-profits will most likely have to rely on for survival. However, this last ditch effort for survival will eventually be deemed unsuccessful; the domestic trend regarding the public's perception of corporation's social responsibility is doing nothing but becoming stronger.

Competency-Based Education: FlexPath

This type of education, or learning, is an approach that is more often used in learning concrete skills than abstract learning. Learners work on one competency at a time, which is likely a small component of a larger learning goal. This type of learning has been used for decades in several educational platforms (e.g., driver's education); however, in regards to postsecondary education, Western Governors University (WGU) pioneered the approach.[13] After years of declining enrollment, Capella University took notice of WGU's success and formulated a similar approach to administer in their programs; this would later be called FlexPath.

According to the company's website, FlexPath is a self-paced style of learning that helps you build the skills employers are looking for at a pace dictated entirely by you – without the constraints of

[12] "Grand Canyon Eyes $2 Billion from For-Profit College Stigma " by Michael McDonald of Bloomberg Business on November 13, 2014.
[13] Western Governors University (WGU) is a private, nonprofit, online American university based in Salt Lake City, Utah. 19 U.S. governors founded the university in 1997.

present deadlines. Currently, Capella is offering FlexPath programs in business, information technology, and psychology. According to Capella CFO Steve Polacek, "…about half of our growth at the bachelors and masters level are coming from FlexPath and the remaining half coming from the credit hour program." Basically, FlexPath is making up the majority of *new enrollment*.

At first glance, the opportunities behind FlexPath seem extremely promising: subscription-based payment model, increased turnover rate, and most importantly, better operating margins. However, the majority of the listed benefits are the exact reason why such scrutiny has been placed among for-profit education participants. Before we go into the details in regards to the FlexPath model, it should be noted that tuition at WGU for comparable programs in noticeably lower; in regards to purely competency based education, Capella is twice as much as WGU (Capella cost per-quarter: $2,000 vs. WGU: $1,000). The chart below is a comparison among online colleges:

Program	WGU	Capella	Phoenix	Grand Canyon	DeVry	SNHU
B.S. Business	$23,120	$32,000	$58,800	$55,800	$67,954	$38,400
B.S. IT	$23,120	$58,850	$58,800	N/A	N/A	$38,400
B.S. Nursing	$13,000	$55,800	$54,300	$55,800	N/A	$38,400
MBA	$13,000	$17,600	Varies	$25,300	$36,798	$24,453
M.S. Education	$11,560	$19,550	$22,230	$19,300	N/A	$22,572

Despite what executives may allude to, there is zero doubt that this company is purely focused on the FlexPath program, and the doctoral program will get progressively smaller. According to the corporate website, learners can be expected to graduate with a bachelor's degree in two-years, and subsequently a masters in half that. If we look at enrollment figures via the National Center for Education Statistics (NCES), the influx of enrollment is not derived from health-related fields as alluded by management, but instead, to bachelors and masters in business administration.

Despite the FlexPath program being operational for several years, career information as well as outcomes is practically non-existent. The sole barometer of effectiveness used by the company is by charting a survey given to graduates post-graduation, using questions like: "Did you receive an award?" or, "Did you receive favorable recognition of your degree by your employer?"[14] By far and away, this is some of the most useless data that I have ever seen published on a corporation's website.

So, outcomes aside, how does the increased cost (relative to competitors) and lack of quality effect the bottom-line at Capella?

- With the vast majority of new enrollment coming from FlexPath, revenue per learner will decrease dramatically as these programs are exclusively for bachelor's and master's programs only.

[14] According to the data source, "Reponses to the Alumni Outcomes Survey one year after graduation." 4 percent of people received an award and 30 percent of employers reacted favorably.

- Marketing and promotional expenses will need to be increased to realize this new focus; if unsuccessful, this increased cost will undoubtedly adversely affect EPS.
- The heavy bachelor's mix along with the faster process will result in an increased cohort-default rate and be deemed unfavorable in regards to gainful employment.
- Earnings and enrollment will be more volatile due to the fall in doctoral students and increased bachelor's FlexPath enrollment.

Scalability is what brings Capella and its competitors to market; it's a hell of a lot easier to sell bachelor's degree for half price in half the time. Put simply, a for-profit institution will lose this battle; taxes are too high, plain and simple. Additionally, the lack of quality can only be manipulated for several years: cohort-default rates and gainful employment will be more than enough to prove this.

In Capella's eyes, this form of education is perfect for their typical adult learner; namely, for business students with prior experience as well as for military members. In order for a learner to be successful, courses must be completed in a timely manner, or else the subscription model could cost more than the traditional alternative. To Capella, the decreased costs and increased flexibility are just the factors that could attract a corporate partnership (e.g., Starbucks and Arizona State University).

Theoretically, competency-based education consumers should be relatively elastic: by learning on one's own, the university is more of a testing center. The competencies, therefore, will most likely be generic in difficulty and be similar across all colleges and universities. So, why in the hell would anyone, especially an employer, pay twice the tuition to go to Capella University? Two words: They wouldn't.

In fact, the deceit is just as inherent within the FlexPath program as it is in the traditional credit based program. For example, in regards to their newly launched BS in Psychology program, they said "[The Program] is designed around the APA Guidelines for the *Undergraduate Psychology Major*." This statement is on the corporate website, giving the impression that this program is APA certified when it isn't.

According to the transcripts, here is the "Career Outcomes" for FlexPath graduates:

	BS Business	BS Psychology	MBA	MS Psychology
Career Advancement	28%	26%	24%	35%
Changed Careers	6%	11%	13%	22%
Higher Education	1%	2%	2%	4%
Leadership Role	19%	16%	19%	24%
Promotion	24%	21%	22%	19%
Salary Increase	35%	32%	35%	32%
Favorable Degree Rec.	30%	28%	35%	25%
Received Award	4%	3%	3%	5%
Served as Consultant	8%	7%	14%	13%
Conducted Research	8%	10%	3%	7%

Currently, FlexPath only represents about 3 percent of total enrollment in undergraduate and master's degree programs (about 750 learners). In the first quarter of 2015, FlexPath hit 1000 learners, a relatively small amount for the amount of resources that has been allocated to this approach. According to corporate executives, the company expects FlexPath to increase to 5 percent of total enrollment by the end of 2015. Even 5 percent might be a stretch, this will depend on the following factors: additional new program approvals, successful marketing execution, and the execution of non-term based financial aid model.

Marketing expenses will increase double digits through 2015 to promote the FlexPath program. Just as Apollo did to combat increased associate admissions, Capella included assessments and mandatory orientation prior to the first course; this will impact new enrollment growth among undergraduate degrees negatively, a key driver of total enrollment growth. This strategy would be fine if postgraduate growth was growing; this illustrates the significance of retention rates.

The increase in marketing will increase their percentage of revenue to marketing; a metric that regulators tend to focus on. In Q2 the company will increase marketing expenses over 10 percent from a year earlier; if we combine this with admission advisory services, this brings the total marketing as a percent of revenues to over 30 percent. With over 80 percent of revenues coming from the taxpayers, how is it legal to spend over 30 percent of revenue on marketing expenses?

According to the National Center for Education Statistics, undergraduate business degrees are by far the most popular among college graduates; the popularity is similar in postgraduate education as well. The unfortunate truth behind this business popularity is that, unless received from a top-tier university, the marginal economic benefits are minimal at best. For example, half of the tenure track professors at business schools stem from only 16 schools.

When we go down the list from doctoral to an MBA, the outcomes are just as negative. One of the sole benefits of an MBA program is to learn from the diverse background of fellow students, and most importantly, gain connections with your classmates. A competency-based online MBA program lacks these essentials to what makes MBA programs worthwhile. Over twenty percent of all college graduates hold a bachelor's in business administration, to say that this market is oversaturated would be an understatement. Additionally, another FlexPath program is in psychology, the second most popular major amongst current undergraduate students.

This university, and especially this specific program, will eventually dilute the brand equity that it has managed to retain over the years, and once again choose quantity of quality. As evidenced by industry peers, this strategy will deliver short-term profits that will result in a long-term loss. The dead-cat bounce in enrollment mirrors this idea, and will only serve as a precursor to their inevitable decline.

Insider Transactions

Stephan G. Shank, director and founder of Capella Education Corporation, has sold almost 20 percent of shares over the past several months. Shank holds about $50M of the $56M total held by insiders; he currently owns 6 percent of the outstanding shares.[15] The chart below illustrates insider activity since November 2014:

[15] This insider activity illustration is from Financial Visualizations (www.finviz.com)

Insider Trading	Relationship	Date	Transaction	Cost	#Shares	Value ($)	#Shares Total	SEC Form 4
SHANK STEPHEN G	Director	Jan 26	Sale	70.01	4,324	302,702	547,980	Jan 26 04:26 PM
SHANK STEPHEN G	Director	Jan 23	Sale	70.00	2,956	206,920	552,304	Jan 26 04:26 PM
SHANK STEPHEN G	Director	Jan 22	Sale	70.01	5,034	352,444	555,260	Jan 26 04:26 PM
SHANK STEPHEN G	Director	Jan 21	Sale	70.00	1,590	111,306	560,294	Jan 22 05:41 PM
SHANK STEPHEN G	Director	Jan 20	Sale	70.00	100	7,000	561,884	Jan 22 05:41 PM
SHANK STEPHEN G	Director	Jan 16	Sale	70.10	2,441	171,120	561,984	Jan 16 05:30 PM
SHANK STEPHEN G	Director	Jan 15	Sale	70.20	1,755	123,193	564,425	Jan 16 05:30 PM
SHANK STEPHEN G	Director	Jan 14	Sale	70.04	6,469	453,115	106,850	Jan 15 04:10 PM
SHANK STEPHEN G	Director	Jan 13	Sale	70.28	3,100	217,862	111,519	Jan 15 04:10 PM
SHANK STEPHEN G	Director	Jan 09	Sale	70.34	3,701	260,325	114,619	Jan 09 05:29 PM
SHANK STEPHEN G	Director	Jan 08	Sale	71.45	13,335	952,722	118,320	Jan 09 05:29 PM
SHANK STEPHEN G	Director	Jan 07	Sale	70.63	7,645	539,930	131,655	Jan 08 05:27 PM
SHANK STEPHEN G	Director	Jan 06	Sale	70.45	9,700	683,376	139,300	Jan 08 05:27 PM
SHANK STEPHEN G	Director	Jan 05	Sale	72.79	9,050	658,777	149,000	Jan 06 04:45 PM
SHANK STEPHEN G	Director	Jan 02	Sale	74.20	8,800	652,993	158,050	Jan 06 04:45 PM
SHANK STEPHEN G	Director	Nov 14	Sale	69.44	3,223	223,794	562,580	Nov 17 04:38 PM
SHANK STEPHEN G	Director	Nov 13	Sale	69.49	14,460	1,004,870	565,803	Nov 13 05:05 PM
SHANK STEPHEN G	Director	Nov 12	Sale	69.54	21,398	1,488,017	580,263	Nov 13 05:05 PM
SHANK STEPHEN G	Director	Nov 11	Sale	68.68	12,600	865,387	601,661	Nov 13 05:05 PM
SHANK STEPHEN G	Director	Nov 10	Sale	68.81	11,398	784,310	614,261	Nov 10 05:14 PM
SHANK STEPHEN G	Director	Nov 07	Sale	69.16	12,925	893,909	625,659	Nov 10 05:14 PM
SHANK STEPHEN G	Director	Nov 06	Sale	69.05	11,088	765,664	638,584	Nov 10 05:14 PM
SHANK STEPHEN G	Director	Nov 05	Sale	69.42	16,400	1,138,442	649,672	Nov 06 05:23 PM
SHANK STEPHEN G	Director	Nov 04	Sale	69.60	21,758	1,514,329	666,072	Nov 06 05:23 PM
SHANK STEPHEN G	Director	Nov 03	Sale	70.06	14,360	1,006,108	687,830	Nov 03 05:23 PM
SHANK STEPHEN G	Director	Oct 31	Sale	71.26	46,974	3,347,522	702,190	Nov 03 05:23 PM
Thom Gregory W	SVP & General Counsel	Oct 30	Option Exercise	53.91	5,400	291,114	5,846	Nov 03 05:04 PM
SHANK STEPHEN G	Director	Oct 30	Sale	71.39	13,416	957,827	749,164	Nov 03 05:23 PM
Thom Gregory W	SVP & General Counsel	Oct 30	Sale	71.36	5,846	417,199	0	Nov 03 05:04 PM

Education Quality

> "*…government support for mass higher education has always been intended to supply skilled labor, boost economic growth, and encourage social mobility through increased wages and employment. However, skewed incentives and information asymmetries have increasingly shifted educational resources away from human capital investment and toward present consumption*."
>
> – Mike Kimsovick of Harvard Law School

As a corporation, proprietary institutions do not have the same relationship as non-profit do with their students; at for-profit universities, education is a product, and students are customers. This student-as-customer approach creates pressures toward grade inflation and lower educational standards because the proprietary institutions depend solely on enrollment for revenue. Therefore, like any business, the company must focus on customer satisfaction, even if this creates adverse effects in the long-term.[16]

The theory explains the overwhelming customer satisfaction statistics that is currently being reported for the FlexPath program. With enrollment in steady decline, management had to improve consumer satisfaction in undergraduate studies as doctoral participants were frustrated and in a steady decline. However, the short-term benefit is in fact, short. In prior years, cohort-default rate manipulation could hide the impending problem; this is the exact reason behind the gainful employment rule.

Like some uninformed investors, students often wrongly assume that past employment trends will persist into the future. As evidenced in Kimsovick's paper, the change in trends during the lag-time of school is known as *cobweb cycles*[17]; this is illustrated by the law school dilemma noted earlier. In addition to the forecasted effects on the health profession at for-profit schools, we believe this will also add to the already deteriorating doctoral at Capella University.

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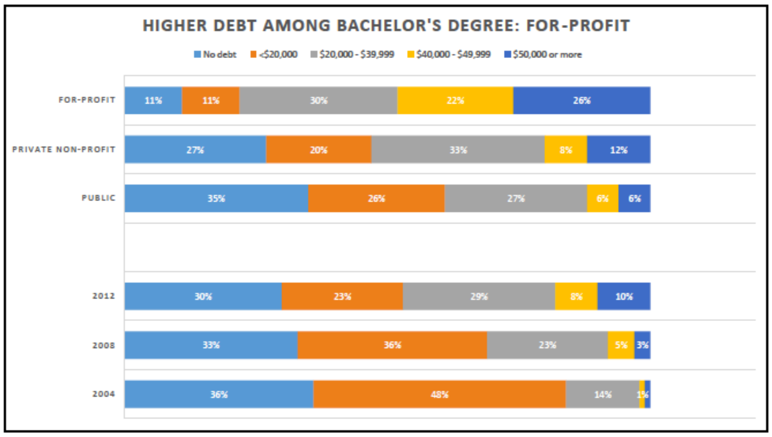
[16] Simkovic, Michael, Risk-Based Student Loans (September 5, 2011). Washington and Lee Law Review, Vol. 70, No. 1, p. 527, 2013.
[17] The New Financial Order: Risk in the 21st Century – Robert Shiller.

Prospective students are typically better informed of starting salaries than about potential increases, and often overestimate the importance of a starting salary relative to lifetime earnings. In the case of the majority of for-profit university students, it's not they are uniformed, but misinformed by aggressive and deceptive recruiters. Many assume that tuition is a reflection of educational quality; however, that is often not the case.

Over the last couple of years Capella University has maintained enrollment numbers at the expense of education quality in order to improve short-term customer satisfaction. In the future, as transparency increases and gainful employment metrics are released, prospective students will be better informed about the metrics that matter: debt-service-to-income, lifetime earnings, and future employment projections. The chart below illustrates the consequences[18]:



Conclusion

Postsecondary education is currently undergoing a generational transformation. Despite the level of optimism and lack of alternatives among prospective college students, many are now coming to the realization that college is not always the best option. More importantly, unlike students of the past decade, cost should be a determinate variable in educational decision-making. As the price conscious consumer enters the education market, corporations are unlikely to be able to compete with non-profit subsidized institutions.

In the past, cohort-default rates and other metrics were easily manipulated; in the future, gainful employment figures will be invariably difficult to manipulate, and thus, will finally tell the true tale of educational efficiency. For-profit institutions initial success stemmed from their ability to adapt; more specifically, their ability to pioneer distance education technologies. For-profit institutions thrived for years due to customer satisfaction; ironically, the industry forgot to satisfy their largest customer: the federal government.

As the majority of outstanding student loan debt begins to enter repayment, the manipulation will slowly be unable to control; the public will finally get their first glimpse inside the toxicity behind the $1.3 trillion debt. Executives at Capella Education undermine their enrollment sensitivity to the broader trends and industry downfall. When the actual results surface, Capella University, as well as the rest of the industry, will find themselves in the shoes of their students: broke, no alternatives, and dealing with one pissed off creditor.

[18] Source: NCES, 2004, 2008, and 2012. "The student-loan trend that's a cause of concern" by Jillian Berman via Marketwatch.

INTEREST MAY BE <u>ONLY</u> MADE THROUGH DEFINITIVE SUBCRIPTION DOCUMENTS BETWEEN A FUND AND AN INVESTOR.

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