This 3DAdvisors Report Covers:	
	Insider Trading: Insider Trading Behavior
	Accounting: Quality of Earnings Issues
✓	**Governance:** Corporate Governance Issues
	Fundamentals: Analysis of fundamentals
	Deception: Deception detection analysis

Compensation Practices May Draw Unwanted Scrutiny
Sector Notes: Strayer Education Inc. (NASDAQ:STRA)

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Introduction

Over the past year, some of our research has been notably focused on several different sectors where we have observed significant anomalous insider trading behavior. Beginning in mid and late 2008, for example, we covered several of the for-profit education companies, and then in early 2009 we noted and covered a significant pick up in meaningful trading among names in the "dollar store" group, certain other retailers, and in the restaurant group. As a result of these sector concentrations in our recent coverage, this is the first of several reports where we provide "sector notes" on a name or names in a particular group or sector where we have done significant work on a number of companies and have uncovered incremental new information on individual companies or the sector itself that clients may find useful.

In this first sector notes, we provide new information on Strayer Education Inc. (NASDAQ: STRA) from the for-profit education group. Over the past year, we have covered several names in the group, including STRA, as summarized in the table below.

Date	Ticker	Headline	Insider trading	Accounting	Governance	Fundamentals	Deception
03/06/09	ESI	Research Notes	✖				
02/10/09	ESI	Still Dodging Key Questions; Insider Selling Increases	✖	✖		✖	✖
01/26/09	APOL	New Risks in Alleged Effort to Manipulate Default Rates	✖			✖	
12/09/08	STRA	Research Notes	✖				
12/09/08	CPLA	Research Notes	✖				
11/24/08	ESI	Direct Student Loans Far More Risky Than Admitted	✖	✖		✖	✖
11/24/08	ESI	Analysis of 3Q08 Conference Call Transcript					✖
10/15/08	APOL	Weakening Economy and Competition Increase Risks		✖		✖	

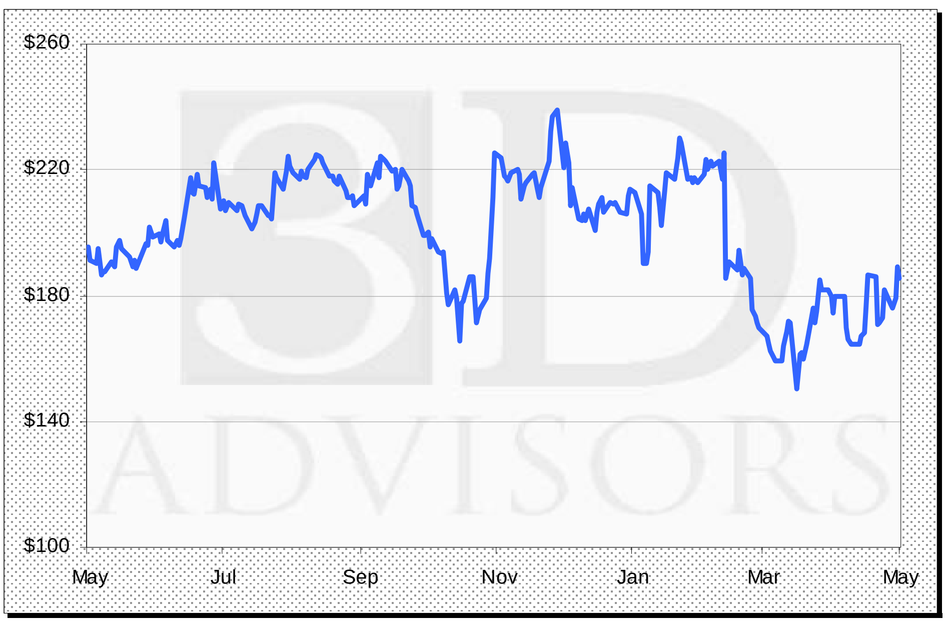
Strayer Education Inc. (NASDAQ: STRA)

STRA reported strong results last Thursday (04/30/09) for the three months ended 03/31/09 before the market open. Revenues increased 28% to $124.5 million, compared to $97.1 million for the same period in 2008, due to increased enrollment and a 5% tuition increase which took place in January 2009. Net income was $29.1 million compared to $23.5 million for the same period in 2008, an increase of 24%.

We think investors were surprised that enrollment growth had increased 22% from the prior year. Some analysts have been anticipating a slow down in enrollment growth that had made many of the for-profit education companies extremely popular recession plays and pushed up their share prices to unprecedented levels. On the strong 1Q09 results, STRA shares were bid up as high as $198.63 during the session, or nearly 11% from the prior day's close, much of which was probably driven by short covering.

The rally following the 1Q09 results represented more of a recovery from the closing low of $150.45 on 03/16/09 as is clear from Figure 1 below. Still, STRA has one of the highest percentages of its float held short in the for-profit education group, as investors think the enrollment growth will eventually slow as the economy improves and defaults on student loans begin to cause problems.

Figure 1. STRA Daily Closing Price, 05/01/08 through 05/01/09. Source: Reuters.



But in reviewing the trading profile at STRA and the 1Q09 results, we came across another risk to STRA shares in the governance area that was first disclosed some time ago but until now has received little attention. However obscure, what we found happens to represent one of the more unusual and self-serving compensation practices we have ever encountered.

Though perhaps not as specious as some behaviors at Apollo Group Inc. (NASDAQ:APOL) and ITT Educational Services Inc. (NYSE:ESI), we think the aggressive way in which STRA executives are paying themselves represents an additional risk to the shares as it could draw unwanted media and regulatory attention at a time when the Obama administration has already shown a willingness to make bold changes in education policy. We think this is a very real risk because excessive executive compensation, especially when the enterprise is being supported by taxpayer dollars, has caused such a public outcry that it has become a political third rail for government policy makers. Strayer, like many of its peers, receives the bulk of its tuition dollars (72%) from students borrowing money under federally funded Title IV programs. The egregious compensation practices at STRA have the potential to encourage more aggressive policy changes that could impact the entire group.

<u>Governance: Insiders get paid to hold vested stock options, unvested restricted stock</u>

It is without a doubt that we can say, in our almost 30 years of monitoring insider behavior, we have never seen a situation where a Company makes cash payments to its insiders who choose to hold unexercised, vested options. Until Strayer, that is. The Company attempts to justify this practice, which has been occurring since 2006, implying, in a weak attempt, that it is in the interest of the Corporation and, in turn, its shareholders [bolding is ours]:

> **Beginning in March 2006, the Corporation began making a cash payment to all holders of vested, unexercised stock options on the same date and in the same amount as the Corporation's common stock dividend to encourage executives and directors to hold such options, and therefore better aligning their interests with those of the Corporation.**

Not since before Sarbanes-Oxley, when many companies loaned money to executives to purchase stock, have we seen such a blatant example of putting cash in the hands of insiders under the guise of encouraging ownership. To date, this is the only example of such behavior that we have seen.

Making the matter more interesting is the fact Strayer has granted options only sporadically over the years, and to just a few key individuals. To this, we note that the three main beneficiaries of the above practice are none other than CEO **Robert Silberman**, CFO **Mark Brown** and Chief Administration Officer, **Lysa Hlavinka**. Thus far, between 2006 and 2008, Silberman has received just under $1.2 million for holding on to his options; Brown and Hlavinka have taken in much less during the period, $153,000 between them. In all, Strayer has paid out $1.6 million to certain executives, who have been holding options, to continue to do so without exercising and selling. The amount may not seem large. The fact, however, that the behavior is centered on three members of management with the highest amount of visibility brings an interesting question to mind: could it be said that the Company is "paying off" these executives to hold their options and stock. After all, if they are going to receive significant cash payments for holding options and stock, why bother selling?

Adding fuel to our interest in the above practice, which admittedly applies to just a few highly visible insiders, is yet-another behavior which inures to the benefit of a much broader Strayer constituency. This is the Company's payment of dividends to holders of its un-vested Restricted Stock. Though the practice is not as rare as the above-mentioned cash payments to option holders, it is hardly a widespread one. For certain members of Strayer management, however, it has proven to be quite profitable, especially in 2008 when the Company not only hiked its regular annual dividend $0.50 to $2.00, but also when it paid a separate, special dividend of $2.00 per share. The Company has offered little explanation or disclosure as to the reason for the special dividend paid out in 2008.

The chief beneficiary of the above two practices was Chairman and CEO Silberman who was paid an extra $968,808 in 2008 between options ($475,000) and dividends on unvested Restricted Shares ($476,608). This overshadowed his 2008 salary of $665,000 by 145%.

<u>Governance: Proxy disclosure overstates insider holdings</u>

Across the board, holdings of STRA insiders are overstated as the Company chooses to include unvested restricted shares in its insider holdings as reported in its Proxy. For instance, the 2009 Proxy states that as of March 5th, Silberman holds 289,989 shares, or 2% of the outstanding shares. This number, however, includes 183,680 shares that had just been granted to him on February 10th but will not vest until 02/10/19 (the 10-year vesting is unusual, but he is getting paid to hold them anyway). His actual *actionable* holdings are only 106,309 shares. The same is true for COO **Karl McDonnell**, whose holdings in the Proxy are listed at 69,469 shares, however only 450 of them are actually actionable; the balance being 69,019 unvested Restricted Shares.

The practice not only presents a picture of actionable insider holdings that distorts and overstates each individual's true exposure and commitment to Company shares, but more importantly obfuscates the true effect of any selling that may occur. On the surface it would seem that selling has been relatively light in the past year. In actuality, the reason one may sense little selling from top management is largely because they actually hold relatively few actionable holdings, despite what might be suggested in the Proxy. In addition, this in direct contrast with what the Company states in its Proxy regarding executive ownership retention guidelines (see below).

<u>Governance: Vague rules undermine significance of holdings guidelines</u>

Given the amount of extra compensation thrown at STRA insiders as outlined above, and the fact that the shareholdings of Company insiders are thin, never mind the illusory practice of reporting unvested Restricted Shares as part of each insider's holdings, we are not surprised that management selling seems light. That is, selling by those other than Silberman. However, Silberman raked in $2.12 million in salary, bonus and above-mentioned payouts in 2008 before selling a single share. He received a new unvested Restricted Stock grant this February of 183,680 shares for which he will annually receive dividends totaling $367,000 for the next 10 years (assuming the current $2/share dividend rate).

It would seem that Silberman should not need to sell given that he is paid handsomely for just holding onto to his options and restricted stock, but as we reported in an issue of *Research Notes* on 12/09/08, sell he did last December, when on the very day they vested, he cleared out of 131,478 of his Restricted Shares. Indeed, seemingly in spite of his generous perks and salary combined, Silberman stands out as the most opportunistic seller in the Company, clearing out of just under 332,000 shares during 2008 with the shares in all-time high territory and taking in over $65 million in profits.

Not surprisingly, the loose executive ownership “recommendations” of the Board of Director’s Compensation Committee did not deter Silberman from selling. We would call the ownership guidelines more a “recommendation” in that they are easily side-stepped by management. From the 2009 Proxy:

> The Corporation’s guiding principles are focused on encouraging officers and directors to think like owners. To this end, the Corporation recommends:
>
> 1. Senior officers purchase outright in the market and hold during their term of employment a meaningful number of common shares; and
>
> 2. Senior officers hold at least 75% of any granted stock options without exercise during the term of the stock options.

The above is what the Company says. What the Company does is clearly different. There has not been an open market purchase by a senior officer since President **Karl McDonnell** and General Counsel Gregory **Ferenbach** each bought *100 shares* in a two-day period in March of 2007. Prior executive officer purchases were sporadic and small, ranging between 100 and 350 shares from 2005 through 2007. In addition, it would seem the cash payments paid by the Company for its executives for holding their options rather effectively dilutes the significance of the second “recommendation” above.

<u>Governance: Board eschews peer group compensation reviews</u>

While Apollo deletes education companies and inflates its peer group analysis with technology companies in order to pump up compensation, Strayer just doesn’t bother to do any peer analysis. From the 2009 Proxy:

> Although the Compensation Committee generally reviews publicly available industry data when reviewing annual compensation, the Compensation Committee does not specifically use companies in the same industry as the basis for establishing the compensation of the Corporation’s executive officers nor does the Compensation Committee peg salary levels to any given quartile in our industry or other industries. Instead, the Compensation Committee attempts to make reasoned judgments of compensation levels for executives as influenced by all relevant market forces.

In fact, most of the Compensation Committee’s decisions are subjectively determined. Again, from the 2009 Proxy [bolding is ours]:

> **The bonus and equity grant determinations with respect to our named executive officers is made on a discretionary basis by the Compensation Committee, subject to the further approval of the Board**. While the Compensation Committee considers various factors in determining the level of any bonus or equity grant payable, including the achievement of certain

> corporate financial targets, ultimately, no one factor is dispositive or material to the determination process. The Compensation Committee considers a wide variety of factors in its discretionary determinations, including academic improvement measures such as graduation and retention rates, improvements in student learning outcomes, advances in faculty hiring and qualifications, and development of new academic programs. The Committee also considers numerous non-financial targets, including compliance with all regulatory, legal and ethical business standards, the number of new campus openings, regulatory approvals to operate in new states, performance of the Company's online business, increases in corporate and institutional customers, and other operational performance measures. Finally, the Committee also considers five separate financial targets (revenue, operating margin, operating income, net income and earnings per share) and capital redeployment steps. While the Compensation committee believes that each of the various targets is itself relevant to its determination of compensation, the achievement of any one target, or for that matter, any particular combination of factors, would not result in a specific bonus amount being paid to our named executive officers…

To us, this long winded description of how the Compensation Committee determines executive compensation can really be summed up by saying the Compensation Committee pretty much does what it wants. The unusual practice of paying executives dividends on vested stock options is evidence enough of that fact.

Indeed, given the Restricted Stock awards doled out to Company executives in February, it is quite evident who on the team holds the cards in the eyes of the Board:

Named Executive	Title	Restricted Shares Granted
Robert S. Silberman	Chairman & CEO	183,680
Karl McDonnell	President & COO	45,920
Mark C. Brown	EVP & CFO	1,240
Lysa A. Hlavinka	EVP & CAO	1,102
Gregory Ferenbach	EVP & GC	918

In turn, with Board Compensation for 2008 ranging between $78,000 and $113,000 per director (excluding Silberman, who takes none for his director duties), it seems evident that both Silberman and his Board have made sure each side is taken care of.