3D ADVISORS

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

New Risks in Alleged Effort to Manage Default Rates Apollo Group Inc. (NASDAQ:APOL) Update

January 26, 2009

Contact: Bob Gabele (954) 779-3974 or bgabele@3DAdvisors.com

Business Description

Apollo Group Inc., through its subsidiaries, provides various educational programs and services at high school, college, and graduate levels. Its subsidiaries include University of Phoenix, Inc. (UPX), Institute for Professional Development, Inc. (IPD), The College for Financial Planning Institutes Corporation (CFP), Western International University, Inc. (WIU), and Insight Schools, Inc. (Insight). As of August 31, 2007, the company offered its educational programs and services at 102 campuses and 157 learning centers in 40 states and the District of Columbia; Puerto Rico; Alberta and British Columbia; Canada; Mexico; and the Netherlands. The Company was founded in 1973 and is headquartered in Phoenix, Arizona.

Summary of 3DAdvisors Findings for APOL

- **Insider Trading:** A significant cluster of insider selling emerges in a familiar pattern
- **Fundamentals:** Reliance on Associate degree programs grows even more risky
- **Fundamentals:** Company may have attempted to manipulate reported default rates
- **Fundamentals:** Questions still remain about enrollment counselor compensation
- **Fundamentals:** Competitors appear to be offering more for less

---

Discussion of 3DAdvisors Findings for APOL

On 01/08/09 after the market close, APOL reported strong results for its 2009 fiscal first quarter (ended 11/30/08), continuing the momentum from the prior quarter. The Company said that revenue increased 24% and operating income 40% from the year ago period, while degreed enrollment reached a record 384,900 or 18% more than last year at the same time. In the press release, CEO **Chas Edelstein** explained, "Our flagship University of Phoenix contributed significantly to our results, and we are very pleased with the continued growth in bachelor degree seeking students, which is an important market for us."[1] In the ensuing session, APOL traded nearly 4 times its

[1] "Apollo Group Inc. Reports Fiscal 2009 First Quarter Results", Business Wire, January 8, 2008.

average volume and closed up over 10%, at $85.27. The shares got another boost when ITT Educational Services Inc. (NYSE: ESI) reported similarly strong results on 01/22/09; APOL hit a 52-week high of $90 during the session.

There is no denying that APOL and ESI have continued their momentum, and thus far the bulls seem to have been right; student enrollment has surged as the economy has weakened, at least through the most recent quarter. But in the case of APOL, this latest run up in the stock has coaxed 7 insiders into letting go over 1 million shares, resulting in significant holdings reductions for some key insiders while representing probably the most significant cluster of selling we have seen from any single company so far this year. For those unfamiliar with the trading history at APOL, clusters of insider selling such as that which has just occurred have served in the past as reliable predictors of significant price volatility. In addition, digging a little bit deeper into last quarter's results and conference call, we see a continuation of some trends and unanswered questions that could have implications for results in coming quarters and may also have relevance for significant new legal and regulatory risk that emerged recently in the form of a lawsuit filed by former students in Arkansas. We focus first on the most recent insider trading behavior.

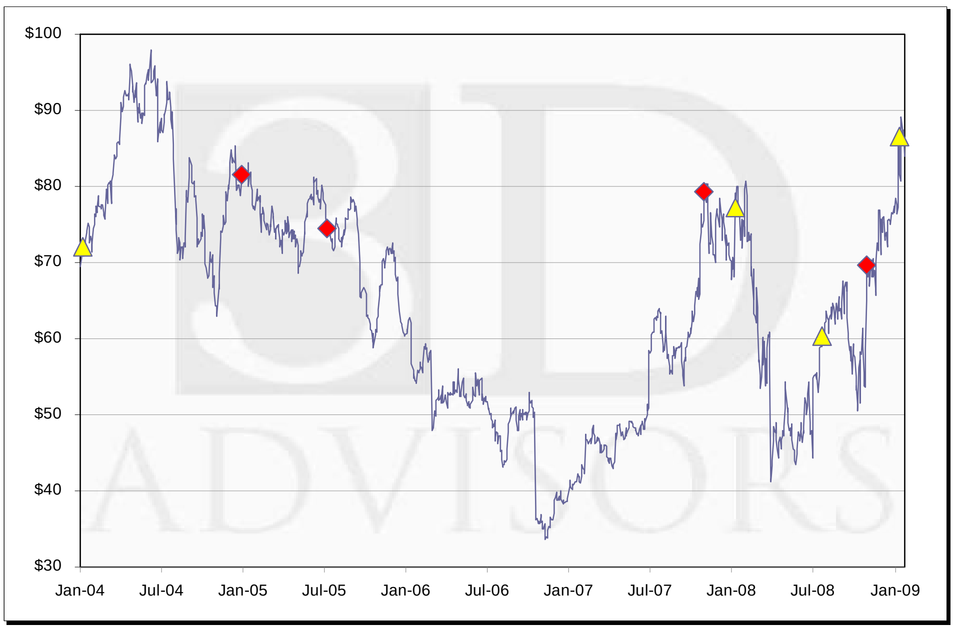
<u>Insider Trading: A significant cluster of insider selling emerges in a familiar pattern</u>

Even though we've seen less trading over the past year by APOL insiders due to pending legal and regulatory matters and the fact that there have been significant changes to the management team, the recent action of insiders in the wake of the fiscal 1Q09 results has a very familiar ring to us as seven insiders converged to sell 1,030,777 shares at prices from $83 to $89. The most notable seller of the group is President, CFO **Joseph D'Amico** (59), who surfaced on 01/15/09 with his first sale since joining the Company in December 2006. He monetized all 166,000 of his vested options, granted to him upon his hire, which were not set to expire until July 2011. Excluding the 47,000 unvested restricted shares the Company reports him owning in the recent Proxy, **the sale wiped out 95% of his actionable ownership**. This sale represented a sentiment reversal as D'Amico was a buyer back in April, picking up 10,000 shares on the open market at $44 following the issue's precipitous 32% sell-off on the Company's FY 2Q08 earnings release.

Another seller of interest is **William Pepicello** (59), President of University of Phoenix, who has been with APOL since 1995 but assumed his current position in December 2006 following the unexpected resignation of **Laura Palmer Noone**. UOP accounted for 94% of net revenue in the most recent quarter. On 01/15/09 he monetized 40,000 options awarded to him in June 2006 which vested early for attaining unspecified operational goals. The options **accounted for 45% of his actionable holdings** (common stock plus exercisable options) and would not have expired for another seven years. This was his second sale since becoming a registered insider, having sold 6,250 shares in January 2008 at $78, which involved the skimming of non-expiring options.

Any discussion of APOL insider trading behavior would be incomplete without highlighting the activity of the Sperlings, the founding family. Over the years we have covered the activity of Chairman **John Sperling** (87) and his son, Vice Chairman **Peter Sperling** (49), both of whom used numerous forward sale contracts to elusively monetize their personal holdings before and during a variety of Department of Justice and SEC investigations. We have also come to find they have used their APOL shares as collateral for personal bank loans. But more recently John and Peter joined their peers in selling stock on the open market in January in addition to delivering shares to third party investors when some of these earlier forward sale contracts expired. This month the two sold or delivered a total of 2.6 million shares and have now disposed of 6 million shares in the last year, which equates to 25% of their combined holdings. Going back to early 2004, when Peter or John or both have surfaced to sell shares, more often than not, the stock has experienced significant price volatility not long afterwards. We should also add that together they are obligated to settle forward sales in April that cover another 1.1 million shares.

Figure 1. APOL Daily Closing Price, 01/02/04 through 01/23/09. Red diamonds are the dates where Peter Sperling sold shares; Yellow diamonds are the dates where both Peter and John Sperling sold shares. Source: Reuters and APOL SEC Filings.



Finally, while observers may have noticed there were three board members taking profits in January, we are particularly interested in the fact the three individuals make up Apollo's Audit Committee. In fact, after the option backdating investigation and financials restatements resulted in a number of board resignations, including two of the three Audit Committee members, this new group was tasked with restoring the Committee's credibility. Committee Chairman **K. Sue Redman** (51) monetized all of her vested stock options on 01/13/09 in addition to common stock, **resulting in a 75% ownership reduction**. The options she exercised were not going to expire until October 2017. Director **James Reis** (51), who joined Apollo's board one month after Redman in January 2007, has close ties to John Sperling and even sits on the board of two other companies owned by Sperling (Exeter Life Sciences Inc. and Arcadia Bio-Science Inc.). After buying 2,000 shares in April 2008, for which he paid $44 per share, he reversed his sentiment on 01/13/09 by selling 2,500 shares $83, a healthy profit indeed. Although the shares accounted for only 14% of his position, half of his remaining actionable ownership consists of 8,000 vested options with a $76 strike price (in the money by just

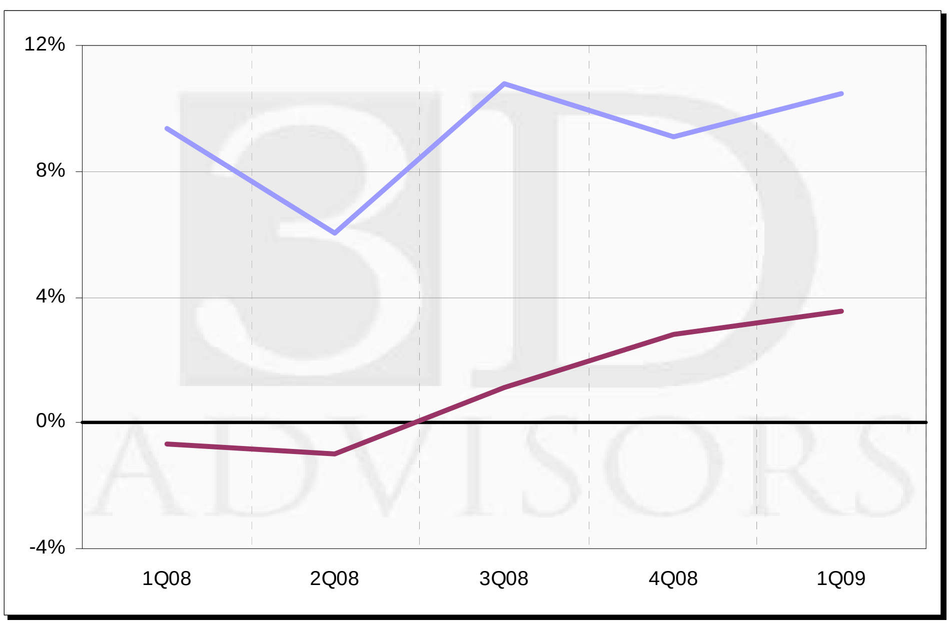
10%). We also note that it is a relatively rare occurrence to see directors acting on the same day as Redman and Reis did on 01/13/09 as it strongly suggests their motivations for selling may be related.

The third Committee member to sell was **Dino DeConcini** (73), the most senior independent board member (since 1992) who was actually on the Audit Committee during the backdating problems and later headed the Compensation Committee in 2007 when they made the controversial (to us at least) peer group switch for benchmarking compensation that increased exec pay by a significant degree. DeConcini, who has a history of selling at opportune times, cleared out an option series on 01/16/09 that still had more than three years remaining before expiration. The 6,500 shares sold were just a small part of his total ownership, but his participation in the recent round of sales is definitely noteworthy.

Fundamentals: Reliance on associate degree programs grows even more risky

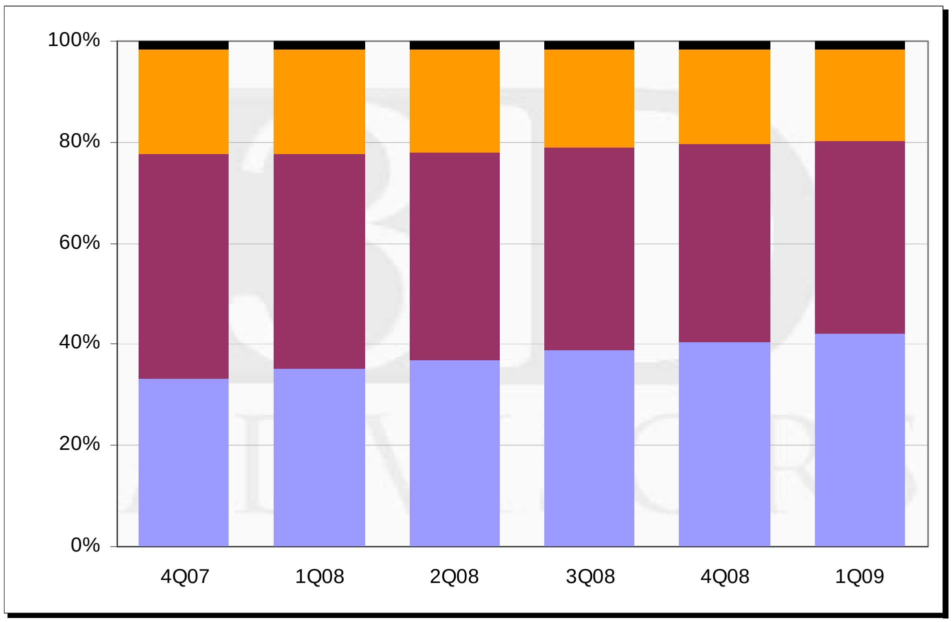
As impressive as the quarter's results were, we also noted that there was a continuation of some trends that we first covered in detail in our update report on 10/15/08 that may have even more dire implications downstream than we originally thought especially if the economy continues to weaken as most economists now expect. Specifically, though CEO Chas Edelstein touted enrollment growth in its Bachelor degree programs, recent growth continues to be driven by increases in Associate degree enrollment, which now has more students enrolled in it than any other program (42% of total enrollments, versus 38% for Bachelor degree enrollments at 11/30/08) and is growing at more than twice the rate of total Bachelor degree enrollments.

Figure 2. Sequential Growth Rates for Degree Enrollments for Associate Degrees (Blue Line) and Bachelor Degrees (Red Line), 1Q08 to 1Q09. Source: APOL SEC Filings.



Associate degree students, in addition to generating less average revenue per student than Bachelor degree students ($2,027 per student versus $2,736 per student in the most recent quarter), are also more likely to drop out or default on tuition loan payments. Given the significantly higher growth of Associate degree enrollment compared to the other programs whose growth is relatively flat, success in convincing Associate degree students to continue their education and enter the Bachelor program is an important stated goal, but the Company is steadfast in its refusal to disclose continuation data. Nor does it disclose drop out or default rates.

Figure 3. APOL Percentage of Total Degree Enrollment by Program. Black=Doctoral; Orange=Master; Red=Bachelor; Blue=Associate. Source: APOL SEC Filings.



We commented at length in our 10/15/08 update report on the risks associated with the continuing reliance on Associate degree programs, a reliance which appears to have increased even more in the quarter ended 11/30/08. We noted, among other things, the relatively poor quality of accounts receivable assets and the Company's muddled disclosures which seem designed to obfuscate the fact that about a third of the receivables are no good (the allowance for doubtful accounts at 11/30/08 was 33.5% of gross receivables). We also made the point that with lower quality Associate degree enrollments becoming a larger portion of the overall revenue picture, combined with the dimming prospects for the U.S. economy and the employment outlook, risks associated with asset quality, and ultimately the Company's ability to keep growing, were increasing rapidly. These trends all continued in the most recent quarter ended 11/30/08, and since then, the outlook for the U.S. economy and the job market has worsened considerably.

Fundamentals: Company may have attempted to manipulate reported default rates

But another related risk that might be even more important is the impact these trends are likely to have on students' ability to repay their student loans as measured by the so-called Cohort Default Rate (CDR), which is a key component in the U.S.

Department of Education's decision to recertify the Company to be a recipient of Title IV student loan money. Such funding accounts for a whopping 77% of its net revenue, and the Company is the largest recipient of Title IV funds in the country (mostly in the form of Stafford Student Loans). It is well known that APOL has been awaiting recertification since June of 2007, and its eligibility has continued on a month-to-month basis as it provides additional information as requested by the Department of Education.

Interest in the Company's default rates and its still pending DOE Title IV recertification ratcheted up to a whole new level when it recently disclosed in its 1Q09 SEC Form 10-Q that three former students had filed a complaint on 12/09/08 alleging that after the students dropped their courses shortly after enrolling, the University of Phoenix improperly returned the entire amount of the students' federal loan funds to the lender in an effort to manage its CDR. The students claimed they were harmed because the Company demanded repayment from them directly under terms that were harsher than would have been demanded by the original lenders under Title IV, and they maintain the Company has done this to manage its CDR. Such manipulation is specifically prohibited under the Higher Education Act (HEA) and would certainly be considered by the DOE in its recertification decision.

Some sell side analysts have dismissed the suit as immaterial. But others find some validity in the plaintiff's claims, otherwise why would the Company give up cash-in-hand for highly risky receivables? Should the plaintiffs prevail and the practice turns out to be widespread (the plaintiffs are seeking class status), the *real* risk to the Company is that if the suit is allowed to proceed at all it gives the DOE just one more reason to further slow down the certification process and could lead the DOE to demand the restatement of earlier CDR data. Some have even suggested that the DOE could ultimately deny Title IV recertification altogether, which would potentially be an overwhelming blow.

It is hard to assign any real probability to this risk, but this much we do know: APOL has been and remains under a microscope by regulators due its multiple past transgressions not to mention the ongoing month-to-month Title IV eligibility as it awaits recertification. In the 1Q09 SEC Form 10-Q, under the section titled "Department of Education Audits and Other Matters", the Company discloses the following [bolding is ours]:

> All higher education institutions participating in Title IV programs must be accredited by an accrediting body recognized by the Department of Education. The Department of Education periodically reviews all participating institutions for compliance with **all applicable standards and regulations under the Higher Education Act**. In the course of **other discussions** with the Department of Education, we were informed that **we likely will be the subject of an ordinary course, focused program review during fiscal year 2009**.[2]

The above disclosure makes it clear that lots of eyes remain on the Company, and further that the aforementioned lawsuit will also get careful scrutiny. These risks seem all the more real considering the Company's checkered history that includes an option backdating scandal and related lawsuits and financial restatements, persistent

[2] Apollo Group Inc. 1Q09 SEC Form 10-Q, filed January 8, 2009, page 21.

and widespread complaints about the quality of UOP degree programs and certain of its practices, and numerous other lawsuits including one that alleged improper compensation of enrollment counselors that caused the Company so much trouble last year and is still not totally resolved. All of these issues, combined with the recent concentration of insider selling that has been reliably predictive in the past, keep our interest in APOL extremely high.

<u>Fundamentals: Questions still remain about enrollment counselor compensation</u>

In January of last year, a federal jury in Arizona found that APOL and two former Apollo executives violated federal securities laws by fraudulently misleading its investors about its recruitment policies and awarded shareholders $5.55 per share, or approximately $280 million. At the time, it was believed that the jury verdict was the largest since the passage of a 1995 federal law governing securities class action suits. However, the Company was able to have the verdict overturned on appeal.

In the class-action, it was alleged that APOL and its management improperly withheld from disclosure a 2004 Department of Education report which claimed that the Company violated federal regulations by paying University of Phoenix enrollment counselors on a per-student basis. The report also claimed that the University kept its incentive-based recruiting compensation practices hidden from the DOE.

Compensation of enrollment counselors is a big deal for APOL; not only does using appropriate compensation policies impact their still pending Title IV eligibility, the Department of Education has been highly critical of the Company's policies in the past, but that it also tried to hide from DOE that it was using illegal practices.

That is why we found the following exchange from the 1Q09 conference call so interesting as it suggests (to us at least) that the Company may still be still using some form of variable compensation (read: commissions) that are a function of the number of students the counselors enroll at the University of Phoenix:

> **Analyst:** Thanks. Joe, I just wanted to ask about the enrollment counselor compensation because I got the point that it is sort of stable as a percentage of revenue but I don't think about it as being a variable cost as much as a fixed cost and I notice there was sort of a $10 million sequential increase. Is that due to the new hiring you mentioned or is there bonus money in there? What accounted for that?
>
> **Joe D'Amico, President, CFO, and Treasurer:** Well, year-over-year there is an increase in enrollment counselors.
>
> **Analyst:** Yes. The sequential increase is what I was looking at.
>
> **Joe D'Amico:** Well...
>
> **Analyst:** From the last quarter.
>
> **Joe D'Amico:** Well, there certainly are more people and people with more tenure, so there could be compensation adjustments obviously for those people.

Obviously, we had a very good quarter in terms of the effectiveness of enrollment counselors. So we have a lot of people doing quite well.

Analyst: Does that translate into their comp somehow in the quarter?

Joe D'Amico: The ability of our enrollment counselors, the tenure of them, certainly does.

Analyst: Right. But you said that you had a very good quarter, which you clearly did, and you said that that played some role in the comp. I'm just trying to understand that.

Joe D'Amico: Its one part of performance and the performance of our group, as a whole, is definitely better. I think in part better because they're longer term employees with more experience.

To us, the above communication/disclosure may suggest that Apollo has found a way to circumvent the Title IV taboo of paying variable compensation to enrollment counselors; simply promote those who are doing well. Such practices, we are told, were commonplace during the Nixon era of wage and price controls. At that time, certain employers looking to circumvent the regulations would simply promote individuals to higher pay scale positions (or alter other benefits) thus circumventing the spirit of the rules requiring mandatory compensation freezes.

<u>Fundamentals: Competitors appear to be offering more for less</u>

Our discussion of University of Phoenix would not be complete without some comparison as to how it stacks up to its competition. It's commonly known that its tuition costs are much higher than many traditional, and well-regarded, brick and mortar institutions. With new players, such as Grand Canyon Education (NYSE:LOPE) in the picture and many of them raiding Apollo for staffing, there should be little question that such entities are looking for pieces of Apollo's market.

The upcoming IPO of Bridgepoint Education (read: Ashford University) poses yet-another challenge for Apollo. A contact of ours worked with an Ashford counselor in order to get a comparison quote for the cost of an undergraduate degree. The applicant would have been coming in with zero credits and seeking a four-year degree. The degree from Ashford would cost $38,190 while its equivalent from University of Phoenix (Apollo) would be $61,800. Ashford receives its accreditation from The Higher Learning Commission of The North Central Association of Colleges and Schools (www.ncahlc.org). Such regional accreditations are considered more desirable than those of national bodies. University of Phoenix is also accredited regionally.

Bridgeport also counts among its senior staff numerous Apollo alumni. Bridgepoint CEO **Andrew Clark** worked for Apollo from 1992 to 2001, last serving as a regional V.P. He jumped off the APOL ship for Career Education (CECO), but joined Ashford a year later. Chief Admissions Officer **Christopher Spohn** was also at APOL from 1996 to 2001, last serving as the Senior Director of Enrollment for the Southern California Campus. Bridgepoint's Chief Admin Officer also worked for Apollo through 2003, but the most recent defect was Bridgepoint's General Counsel, **Diane Thompson**, who left APOL in November 2008 and joined Bridgepoint a month later. She was with APOL for more than ten years and was the head of Human Resources before she left.

On a final competitive note, in this tough environment, one would expect placement counseling to be an important selling point to a student choosing a school. Not so at Apollo where all indications point to the absence of any plans to offer such services even in the future. President, CFO Joe D'Amico succinctly says it all:

> **Analyst:** And with the tough economy, anything that you're doing with regard to placement counselors or working with your students that are graduating and going out in this environment, just anything you can speak on there?
>
> **Joe D'Amico:** Well, we don't do placement and a number of our graduates are working adults. So that's the answer.

Although Apollo does not offer such services, we note that virtually all its competition does. The only other exception we could find was Strayer Education Inc. (NASDAQ: STRA) who also does not offer placement counseling. The following do offer placement services and do have placement counselors:

✓ ITT Educational Services Inc. (NYSE: ESI)

✓ Grand Canyon Education Inc. (NASDAQ: LOPE)

✓ Ashford University (Bridgepoint Education)

✓ Corinthian Colleges Inc. (NASDAQ: COCO)

✓ Career Education Corp. (NASDAQ: CECO)

✓ DeVry Inc. (NYSE: DV)

✓ Lincoln Educational Services Inc. (NASDAQ: LINC)