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

Still Dodging Key Questions; Insider Selling Increases
ITT Educational Services Inc. (NYSE:ESI) Update

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Business Description

ITT Educational Services Inc. provides postsecondary degree programs in the United States. The Company offers diploma, associate, bachelor, and master degree programs in various fields of study, including information technology, electronics technology, drafting and design, business, criminal justice, and health sciences. As of March 31, 2008, it had 100 institutes and 9 learning sites located in 34 states that offered degree programs to approximately 54,000 students. The Company was founded in 1946 and is headquartered in Carmel, Indiana.

Summary of 3DAdvisors Findings for ESI

- **Insider Trading:** More selling by rank and file managers in key positions
- **Fundamentals:** Balance sheet begins to show the impact of direct student loans
- **Deception:** Management still dodging key questions on student loans
- **Accounting:** Miscellaneous noteworthy items

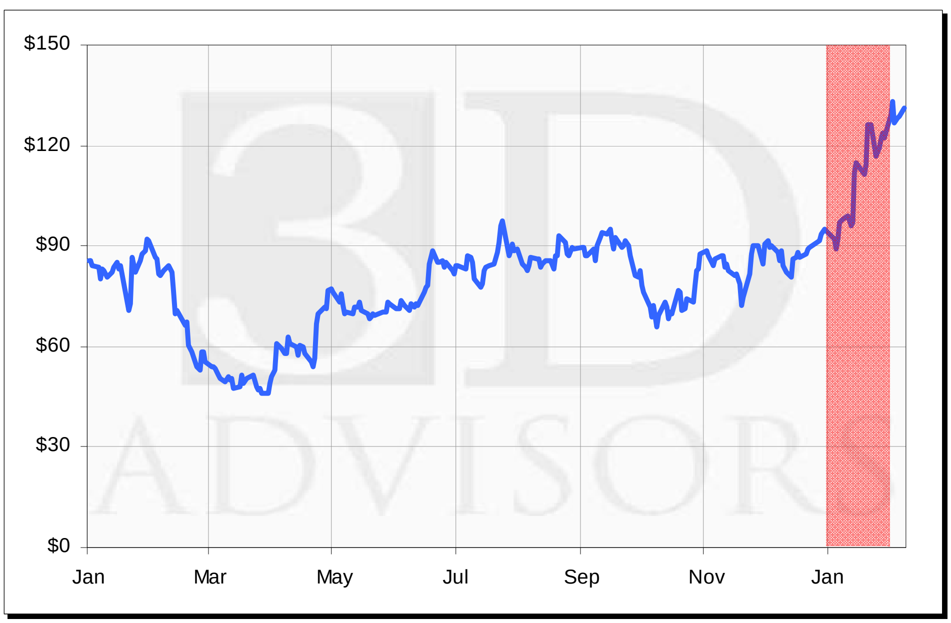
Discussion of 3DAdvisors Findings for ESI

Like many of our clients, our interest in several of the for-profit education names remains strong, most notably ITT Educational Services Inc. (NYSE:ESI) and Apollo Group Inc. (NASDAQ:APOL). Our full report on ESI (11/24/08) included, among other issues, off-the-radar insider sales by individuals who are not required to file evidence of their trades on Form 4 under Section 16, but are required to file a Form 144 (Intention to Sell Restricted Stock) when they sell the restricted shares they hold. The sales of restricted stock by executives, beneath the Form 4 radar and thus missed by many analysts and the media, provided early behavioral clues that management's expectations for further share price gains were weakening, despite the bullish management-speak on conference calls and in other disclosures. This naturally led us to not only take a deeper look into the Company but also keep a weather eye out for any subsequent trading behavior.

Yet the momentum among the education stocks was just beginning as Wall Street rushed in to buy up shares in just about the only part of the market showing secular strength, irrespective of certain management behavior and some key fundamental questions that were, in our opinion, clearly flashing caution. Indeed, the bulls seemed to be proven right when ESI reported strong growth for its fiscal fourth quarter and full year on 01/22/09, pumping the shares up 15% to trade at over $130. Incredibly, *after* the shares had rallied, a Credit Suisse analyst raised his rating on ESI on 02/02/09 to “outperform” from “neutral”. We say “incredibly” as we’ve all seen this sell-side bandwagon-jumping *after* a stock has made a big move, but it is rare when there are so many questions about both the company and the bear market environment.

Just as the misguided analyst at Credit Suisse and other sell-side “experts” were reiterating their bullish stance on the shares, almost on cue, ESI insiders gave their own decidedly less optimistic view on the chances for further price gains. The three 144 sellers mentioned in our November report again surfaced soon after the earnings release. They were joined by two new 144 sellers and three Section 16 filers. Most of the group had not been seen selling for quite some time. In all, eight insiders sold a total of 60,431 shares between 01/02/09 and 02/03/09, a fairly significant move given the behavioral norm for this particular management team.

Figure 1. ESI Daily Closing Price, 01/02/08 through 02/09/09. Red shaded area is where 8 insiders sold 60,431 shares. Source: Reuters and ESI SEC Filings.



Meanwhile, management continues its rosy optimism. For instance, just as he did in the prior quarter, CEO **Kevin Modany** used a broad array of superlatives in his prepared text for the 4Q08 conference call, words such as “excellent”, “exceptional”, “amazing”, “incredible”, “terrific” and “impressive”. Virtually nowhere does one find cautionary testimony from this crew. Sorting further through the most recent conference call, however, one gets the impression that, although management continues to put a positive spin on the student financing environment, certain details remain vague. When questioned on those details, the responses leave one feeling as if management is still not 100% confident in its methodology regarding internally funded student financing, estimation of associated bad debt expense and the impact of the weakening economy on the overall business.

Our initial inclination was to wait for the SEC Form 10-K filing (expected in about two weeks) before issuing this update. However, the level of obfuscation and downright caginess displayed in management's responses to certain questions combined with persistent hyping of the stock while some key members of management are busy selling off significant pieces of their own holdings, give us good reason to update clients now and in front of any new disclosures that may appear in the upcoming 10-K.

Insider Trading: More selling by rank and file managers in key positions

In our full report on 11/24/08, we covered selling we had discovered on Form 144 filings, not the Form 4 filings that are tracked by most analysts and the media. For those not familiar with Rule 144, it requires insiders who are selling restricted shares, which are unregistered, to file a de facto registration on a Form 144. This exempts them from the SEC's registration requirements so that the shares can be sold on the open market as if they were registered. We are often interested in these filings not only because they are for the most part off the radar, but because they normally involve mid-level managers deeper in the organization that can reveal clues about the sentiment of those individuals that are much closer to key operating areas of a company.

Just prior to our November report, three such filers had emerged. Their selling interested us not only because they were accepting lower prices than in prior sales but also because we knew most of the investment community would be unaware of the activity. Those sales occurred immediately after the Company's 3Q08 earnings release. Now, immediately following the Company's 4Q08 release we have five Form 144 sellers complimented by three Section 16 insiders acting similarly. Though the number of shares sold does not appear large on the surface, it is particularly interesting to us that mid-level managers involved in operations, accounting and legal areas have surfaced as a group to sell shares in a break from their prior behavior, even though the shares had traded at these same high levels back in 2007. Not only are these individuals in "frontline" management positions and likely to have intimate knowledge of what is really going on in the business, but the shares are also likely to represent a larger portion of their net worth than perhaps do the holdings of more senior executives. If so, they may feel that their net worth is being threatened and are more willing to act than say the CEO who knows all eyes are on his actions.

- **Barry Simich** – V.P. Operations. Between 2001 and 2005 he had served as a District Manager before being promoted to his current position in 2005. Between 1991 and 2001 he served as Director of an ITT Technical Institute. On 02/11/08, he entered into a 10b5-1 plan and began selling 750 shares monthly, each time exercising options and selling out the entire amount exercised. He has acted similarly right into early January where he sold his usual 750 shares. But now for the twist: After the 4Q earnings, he immediately exercised options for 6,000 shares, selling the whole lot on January 27th for about \$116 each. It appears that these sales occurred outside of his established 10b5-1 plan, suggesting a lapse of patience as the shares moved again into these high price levels.

- **Philip Frank** – V.P., Assistant General Counsel and Director of Real Estate. On January 28th, Frank exercised options for 5,400 shares and immediately sold them. There was no indication of a 10b5 plan. Much more importantly, this was Frank's first sale since September of 2006 when he dropped 2,600 shares.

- **Angela Knowlton** – V.P., Controller and Treasurer. Knowlton has held her current position since February of 2006. On February 3rd she sold 1,700 shares in the $129 range. All indications point to this as her first-ever sale. Though the volume seems small, we doubt that it is immaterial as she finds her action clustered in with a group of sellers in a very short time window.

- **John W. Hawthorne** – V.P. Student Services. Hawthorne set up a 10b5-1 trading plan in March of 2008, and then sold 7,184 shares in July at prices below where he had been in prior moves. On January 27th, he exercised options for 2,260 shares, selling them immediately for about $120 each.

- **Gary Carlson** – V.P., Academic Affairs. In his current position since 2002, Carlson has been with the Company since June 1997. He surfaced on January 27th, the same day the other 144 filers acted, exercising options for and selling 2,260 shares. Though Carlson had last sold on July 29th at $88, (10,800 shares) just in front of a drop in ESI shares to $69, he did not initiate a 10b5-1 plan until November 6th. His recent sale, at about $119, is his first since initiating the plan.

Given the fact that the above are not Section 16 filers, we have no holdings data on which to assess reductions in actionable holdings (common stock held plus vested in-the-money options). Suffice it to say, however, that based on holdings data for other members of management for whom we do have holdings data, we are comfortable with our assumption that these individuals have sold significant portions of their holdings with what appear to be on the surface fairly modest sales.

Sellers below, from Form 4 filings, reveal deterioration in the holdings of additional key players:

- **Clark Elwood** – General Counsel. On 01/15/09, Elwood sold 22,061 shares under a 10b5-1 plan opened last August, a sale that covered all of his actionable holdings except the 6,097 shares he holds in his 401(k) plan. He monetized all of his vested options, which came from two series with November 2012 and January 2014 expiration dates (strikes of $55 and $77) plus all 8,304 common he held directly. Since this trade he has vested in an additional 12,329 options with strikes of $77 and $88. So, giving him credit for these newly-vested options, his **January sale reduced his holdings by 54%**. He will not have any additional options vest until January 2010. Elwood was a regular seller in 2006 and 2007, erasing a sizeable ownership position with two different sales plans in two years. In early 2006 his actionable holdings exceeded 230,000 shares; he's now down to just 18,000.

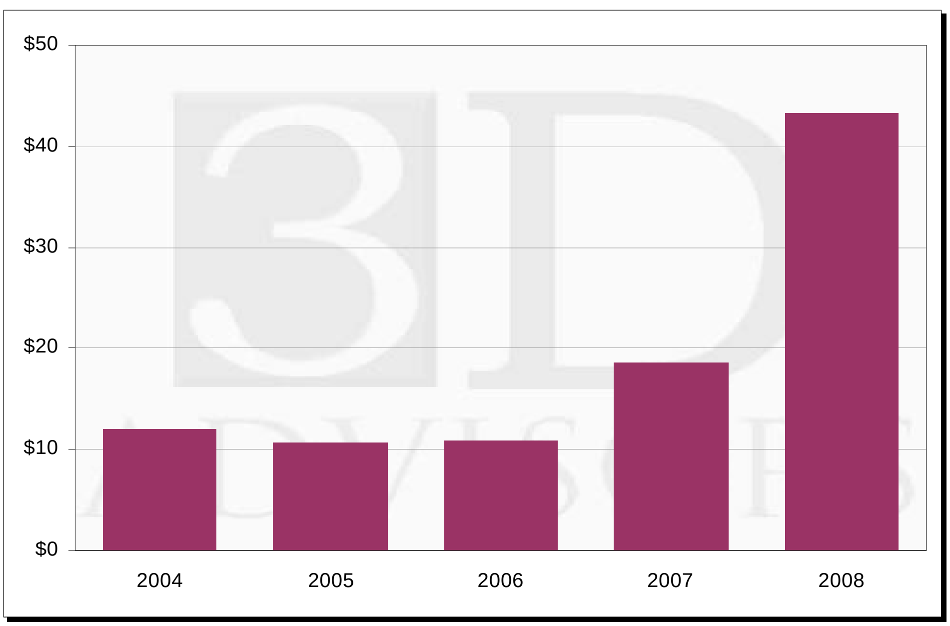
- **Jeffrey Cooper** – Chief Compliance Officer Jeffrey Cooper. Cooper joined the Company in late 2004 and has been an infrequent seller, having sold only once (5,000 shares) in November 2007 with the shares at $123. On 01/29/09 he cleared out his February 2012 and November 2014 series and immediately sold the 15,000 shares at $124 to $125. After four years with the Company, he still has not acquired and held one share of ESI common. Again, taking into account the options that vested right after his trade, **the sale reduced his holdings by 45%**. He won't have any options vesting during the remainder of the year and only 5,600 in 2010 (all in January).

Fundamentals: Balance sheet begins to show impact of direct student loans

Even though ESI claims it has the tools to find its way through the uncharted depths of internal student financing, which exposes its balance sheet to significant new risks with which it has little experience, big questions remain which the Company either refuses to answer clearly or not at all (see below). After all, private lenders have been getting out of the business presumably because the risk profile has changed to such a degree that it does not make sense for them to be making loans to risky student borrowers. Indeed, it is the very withdrawal of private lenders from the increasingly risky marketplace that has forced the Company into the business of making loans directly to students as it has explained in its two most recent SEC Form 10-Q filings: "…we have extended larger amounts of unsecured credit to our students due to a decrease in private education loans made to our students by third-party lenders." [1]

In describing the plan for direct student lending, Modany implies he has reliable data to help guide the way and he disclosed that the criteria used to determine eligibility for internal funding and establishing a related bad debt reserve is "derived from third party private loans that were offered to our students prior to 2008" (prepared text 4Q08 conference call). So it is clear the Company is basing its current criteria on data derived from private lenders who had offered loans to ESI students in the past and now, due to tightening credit standards are no longer doing so.

Figure 2. ESI Bad Debt Expense, 2004 to 2008, Millions of $. Source: ESI SEC Filings.



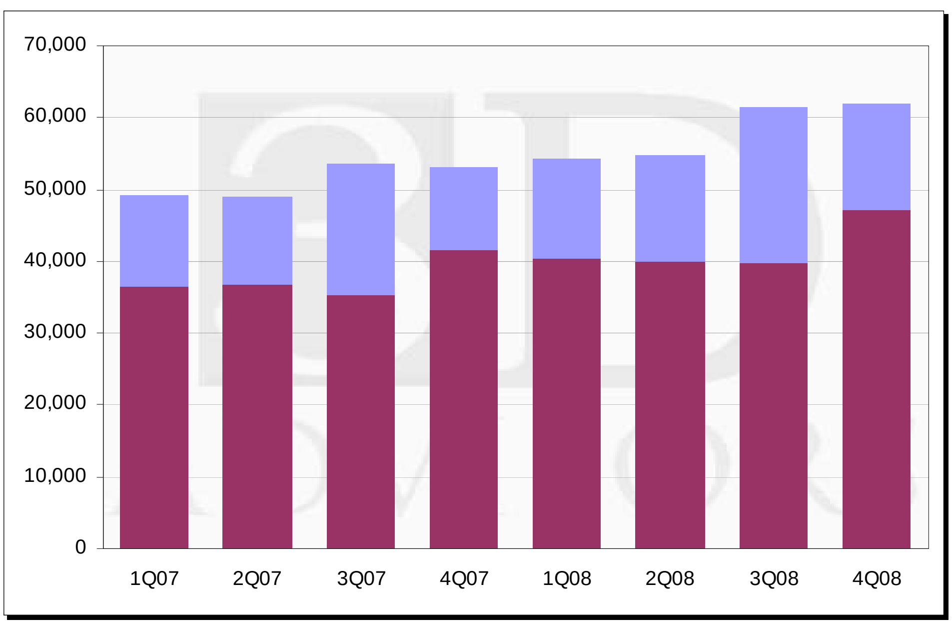
[1] ITT Educational Services Inc. SEC Form 10-Q for the Period Ended September 30, 2008. Page 15.

Whether reliance on the lending criteria used by others when economic times were very different is a good idea or not is debatable, but what is undeniable is the impact direct student loans are starting to have on the Company's balance sheet. Both accounts receivable and bad debt expense continued their upward trajectory in the 4Q08 as well as for the full year. Net receivables increased 96.8% to $29.8 million for the full year, while bad debt expense increased 132.7% to $43.3 million, or 4.9% of revenue, up from just 2.1% of revenue in 2007.

In the opening comments of the 4Q08 conference call, management discloses that they expect bad debt expense as a percentage of revenue to increase to a range of 4% to 6% in 2009. Day's sales outstanding (DSOs) also increased from 6.0 days in 2007 to 9.8 days in 2008 with the expectation that they will increase to 15 to 20 days in 2009. Should DSOs reach 20 days this will be the equivalent of a 233% increase in two years. Management confirms in the same opening comments that these increases are a direct result of providing internal funding to its students.

We would agree with many analysts who would no doubt argue that the damage inflicted on the Company's balance sheet thus far due to direct student financing is relatively modest. As we acknowledged in our recent update on APOL, the bulls seem to have been right thus far, at least in terms of student enrollment growth which has continued to be robust in the face of a worsening outlook for employment and the economy in general. And while ESI management wasted little time in touting the Company's enrollment growth at the top of the 4Q08 press release and conference call, we note that receivables, bad debt expense, and DSOs are all growing at a much faster pace than enrollment, revenue or earnings.

Figure 3. ESI Total Student Enrollment, 1Q07 through 4Q08. Blue bars are "new" student enrollments; Red bars are "continuing" student enrollments. Source: ESI SEC Filings.



Deception: Management still dodging key questions on student loans

Clients may recall that for our full report on ESI in November, we utilized the services of an outside consultant who is an expert in systematically detecting and analyzing "verbal deceptive indicators" in corporate disclosures. We undertook this effort to confirm what we intuitively felt were consistently vague or incomplete answers concerning direct student loan financing and its impact on the business, but to also see if the analysis could help focus our further investigation and fundamental analysis of the Company (for a full copy of the deception analysis performed by our consultant on the 3Q08 conference call, click here). Our consultant identified high levels of verbal deceptive indicators in responses to questions regarding student loan financing but also the impact of the current economic environment on students and the business overall.

Such indicators clearly remain evident throughout the 4Q08 conference call dialogue as the following examples demonstrate. Several times during the call management was asked to clarify and comment on the internally funded student financing program. As has been the trend in the past, they were reluctant to give anything more than extremely vague general comments.

> **Analyst:** Congratulations on the quarter. You didn't comment on what you thought was likely to be the [funding] gap. This question is excluding any pending legislation that you mentioned. But is 12 to 13% still a reasonable gap assuming the full benefit from the 2008 loan limit increase?
>
> **Kevin Modany, CEO:** To be honest, we are probably going to come in a bit better than that, maybe a point or two. There is a lot of moving parts, eligible and whatnot for the title or the Stafford Loans and Pell Grants all the different pieces that changed in 2008. As we gather more information, it looks like we may be a point or two inside of that 12% or 13% guidance.
>
> **Analyst:** That would imply that your students still are getting pretty substantial access from third-party lenders, which obviously is a lot better than the bearish case we assumed. I wonder if you can give us any sense if is it largely one lender, or are there a couple who are doing that. Any color on that would be helpful.
>
> **Kevin Modany:** We have access. The changes in numbers for 2008 are substantial. We don't back away from the fact there has been a material change in terms of availability [of private student loans]. But it's there. I would say it's obviously there at higher levels than probably what some of the most --- strongest pessimist I guess were expecting. Aside from that we are not giving a whole bunch of color, we mentioned that there is one lender providing a large portion of the private loans…

One analyst attempts to understand how management came to determine that $75 million in internal funding would be needed. The response seems to imply that management is "sticking its finger in the air and feeling the wind", so to speak.

> **Analyst:** Then I want to ask about the guidance you suggested on how much of the price of financing you are going to provide $75 million. That number strikes me as very specific in the context. How can you be so

specific? I know you you're not giving guidance on revenue. Is there anything you can give us on that without having a good idea where revenue is going to come in?

Kevin Modany: It's specific as any estimate could be I will tell you that. Obviously inherent in the word estimate is some level of uncertainty. I don't want to give you the wrong impression that we know exactly what it's at. We have a reasonable amount of data. We have been talking about waiting for our ability to collect the sufficient amount of data to give us comfort in the estimate that we put forth. We have taken all the information we had in terms of the underwriting standards, a reasonable estimate of what is going to occur going forward. We have provided that to you to provide the clarity we promised. There is a lot of moving targets; we feel comfortable with that number so we threw it out there.

In terms of bad debt expense, Modany refuses to give any information. We find it almost humorous that he tells the analyst he feels "comfortable" that he is being transparent in providing information on the topic.

Analyst: Lastly, appreciate the description of how you get to bad debt expense, are you willing to give us some sense on a blended average basis what the average number is, is it in the mid to upper 30's? The average reserve you're taking on the loans you made?

Kevin Modany: [We are] not going to give the number but I will give you color and tell you ultimately the methodology that Dan walked you through, results in us having a reserve percentage that's substantially higher than the historical default rate. The accounting methodology or pronouncements will allow you to make adjustments on information based on current environment and Dan and his team have done just that. Aside from that we are not going to get in to specific percentages, there is plenty of information out there to get the number pretty close to it. But obviously we have agreements in place where we can't talk about percentages and what not. I feel comfortable that we are providing a clear and transparent look at where we're at and what we are doing.

Another analyst asks about the funding gap between what a student has as resources available to pay for tuition and the actual tuition cost charged by ESI. We are reminded that management still will not say what percentage of that gap will need to be internally funded with ESI loans directly to the student. As mentioned in the full report on 11/24/08, if ESI does become responsible for the full amount of the estimated funding gap of 12% to 13%, that is a significant jump from the 6% "other" category that was disclosed in the 2007 SEC Form 10-K.

Analyst: Is it possible to characterize what the [funding] gap now looks like on average for an associate degree student and a bachelor degree opportunity?

Kevin Modany: Say that again?

> **Analyst:** Is it possible to characterize the average size of the gap on a per student basis for associate and bachelor student.
>
> **Kevin Modany:** We are not providing that number but with everything we put out there, someone could calculate what the average gap would be. We said 12% to 13% in total. We said 60% of the students are getting a private loan. We are seeing that 12% to 13%, a point or two lower based on the information coming in. You could take that and probably calculate a reasonable number. It's not a metric we are providing guidance or color on at this point.

To this, our question is: if the Company has truly provided the necessary data to calculate the number, why not just disclose the number? Modany does it again, later in the call, when asked about free cash flow generation for 2009:

> **Analyst:** There have been a lot of questions about what free cash flow does in 2009. And strong growth, I was wondering if you provide any directional suggestions of where free cash flow will come in in 2009.
>
> **Kevin Modany:** I will speak for it directionally, if you look at 2008, we had previously talked about $150 million free cash flow target and I'm being compelled to say that that is a non-GAAP measure which is reconciled on the web site. My attorneys are making sure I throw that out. But we ended with $155 million, certainly if you look at just the information we provided you, in terms of EPS, and in terms of the internal financing, DSO, I think your math should result in a number that's north of that. Again we are not giving guidance in that regard. That should provide you enough to get that.

Again, these responses to key questions from analysts are vague, incomplete, or the questions are just not answered and make it clear that management continues its incomplete if not deceptive disclosure practices. Combine that with the fact that the balance sheet has started to show some of the impact from direct student loans and the recent spike in insider selling by both executives and rank and file managers, and ESI remains a name very high on our interest list.

<u>Accounting: Miscellaneous noteworthy items</u>

- **Internally-financed loans will not be easily sold:** We know that with ESI's already-high bad debt reserves, any sale of internally financed student loans would require a significant discount, possibly making the process prohibitively expensive for the Company. The real conundrum facing ESI, however, is whether they will ever be able to get the loans off the books. ESI's 3Q08 conference call contains an interesting dialogue between Modany and an analyst where both talk about the likelihood that such loans will be able to be sold only after graduation and the employment of the student. So we have two significant hurdles: Get the student through school without dropping out and then wait until they are gainfully employed. The bull case for this scenario is that out of work students are more likely to go the distance. To us, it seems that such an assumption is challenged by the weakened economy that forced them into school in the first place: When will they find work? It appears that ESI will find itself unable to sell its growing amount of student loans until well after the graduation of each student.

- **Impact of lower advertising rates:** While reviewing the results for 4Q08, we kept wondering how much benefit the Company got from lower advertising rates, but it was not addressed quantitatively and the analysts did not zero in on it. We thought it might have been a larger factor in improved results than disclosed. In the '07 and '08 quarter comparison, marketing expenditures increased by 5%. The Company had originally estimated that the increase would be between 10% and 15%. We still can't quantify it, but it looks as though it may have provided a significant benefit. Added recruitment representatives will probably drive that metric back up in '09.

- **Ability to increase tuition:** On a quarter-to-quarter comparison, based on the increase in revenue per student (5.9%), it looks as though they must have gotten all or most of the 5% tuition price increase by the fourth quarter. On a year-to-year comparison basis, however, the increase of 3.7% might indicate that implementation took some time after the announced March 2008 effective date. Modany is sticking with the strategy of another price increase in March '09. That might be hard to come by in terms of realization given the worsening economic landscape.

- **Deferred revenue drop:** Deferred revenue dropped from $213.1 million at 12/31/07 to $142.0 million at 09/30/08, a decline of over 33% no doubt largely a function of the funding mix, that is, government versus private. That decline will probably continue, which means less cash up front.