

For-Profit Social Services: From the Trough to the Slaughterhouse?

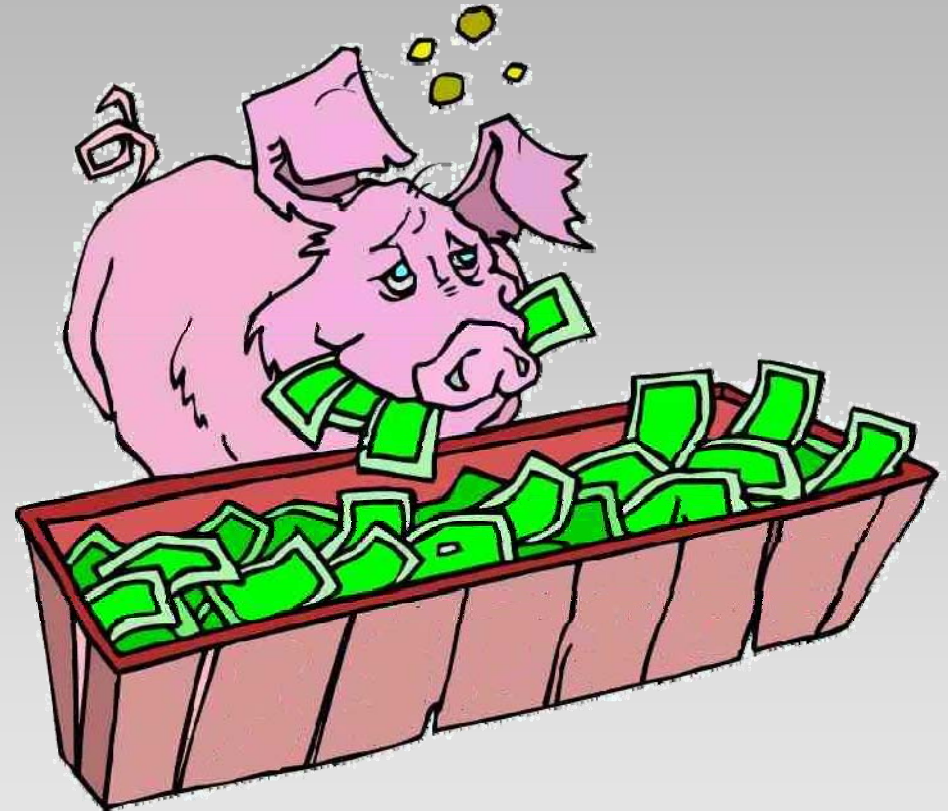
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Pigs at the Trough

The 30-year deregulation boom derived from the view that the private sector always offers a better solution:

- Healthcare
- Education
- Financial Services
- Defense
- Government Services



Inmates Running the Asylum

“There is no kind of dishonesty into which otherwise good people more easily and frequently fall than that of defrauding the government.” –Benjamin Franklin

The increasing intersection between federal largesse and corporate interests resulted in widespread incidents of corporations dictating public policy, systemic abuse and outright fraud.

- Medicare Fraud Allegations (Merck \$400m settlement in *qui tam* case)
- For-Profit Education Shenanigans: Numerous instances of recruiting and lending violations coupled with questionable educational outcomes
- No Bid Contracts at Halliburton, Contracting Scandals at Boeing
- Fannie and Freddie’s Stranglehold on Regulatory Oversight
- Enron Co-Opts US Energy Policy Through The Bush Energy Task Force
- Abramoff and K-Street Ilk Take Over Washington
- Wall Street Changes the Rules: Repeal of Glass-Steagall, loosened derivatives oversight, mark-to-market accounting and eased capital requirements

The Perfect Storm & the Aftermath

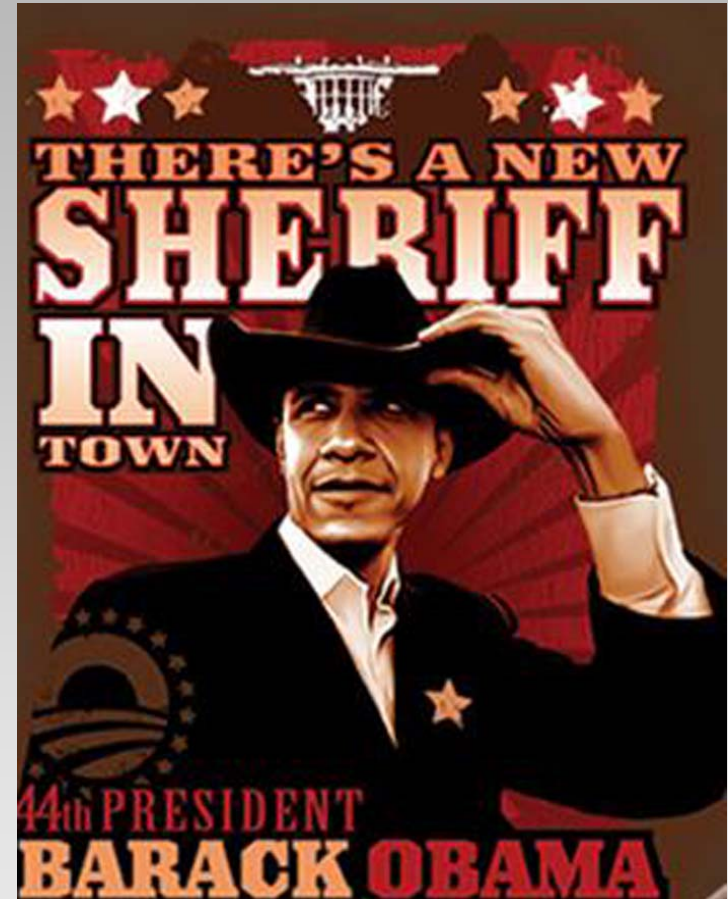
The Outcomes of the Inmates Running the Asylum

- Financial System in Utter Collapse: Market Meltdown and Credit Crisis
- Fannie, Freddie Went Bust, Further Disrupting Housing Market
- Current U.S. Healthcare System Is Troubled
- Explosive Growth in For Profit Post-Secondary Resulting In Large Numbers of Students Saddled With Massive Debt and High Default Rates
- Enron, Halliburton and Other Companies With Close Government Ties Mired in Scandal
- Citizens and Legislators, for the First Time in Decades, Are Calling Into Question the Very Foundations of How Our Economic System Functions

The New Sheriff in Town

President Obama fashions himself as a once-in-a-generation reformer, in the vein of Teddy Roosevelt, FDR and Reagan -- riding into Washington on a wave of populism.

- Obama views access to health care and education as civil rights issues and vital to his legacy
- Administration is not in the business of subsidizing fat corporate margins.
- Wall Street has yet to fully recognize the new reality.



Capitol Offenders: For-Profit Sectors Gain From Social Services

For-Profit Education Companies

- Federal Title IV funding as a percentage of revenue at four largest companies: 73%⁽¹⁾
- Operating margins at four largest companies: 27.3%⁽¹⁾ vs. 12.5%⁽²⁾ for S&P 500

U.S. Healthcare Companies

- Public spending on healthcare makes up 47%⁽³⁾ of national healthcare expenditures
- Operating margins for S&P 500 healthcare sector: 18.8%⁽²⁾ vs. 12.5%⁽²⁾ for S&P 500

(1) Source: SEC filings for APOL, ESI, STRA, DV

(2) Source: Bloomberg

(3) Source: Centers for Medicare and Medicaid Services

Social Services That Are Sold and Not Bought

- Heavily government-supported industries such as for-profit education and Big Pharma have spent disproportionately large sums of money on self-serving advertising and promotion.
- For-profit education companies' advertising costs amount to 53%⁽¹⁾ of educational spending.
- Big Pharma spends nearly three times the amount on sales and administrative costs as it does developing new drugs via research and development.

	For-Profit Education	Big Pharma ⁽³⁾	KFT	WMT	F	PM	MSFT
SG&A/ Revenue (%)⁽²⁾	19.22% (Advertising Only)	31.29%	21.47%	18.90%	14.65%	9.43%	8.49%

(1) Source: SEC filings for the nine publicly traded companies

(2) Source: SEC filings

(3) Source: SEC filings for PFE, WYE, MRK, BMY, SGP, LLY

Costly Lessons: Which Comes First – Students or Profits?

Education Companies vs. Students

- Instructional costs as a percentage of revenue continues to decline (39% in most recent quarter vs. 44% in 2007⁽¹⁾), enhancing profit margins.
- Government money pays for advertising that has fueled double-digit enrollment growth vs. 1%-2%⁽²⁾ for traditional not-for-profit colleges.
- Students at proprietary schools saddled with 58%⁽³⁾ more debt than students at traditional colleges.
- Budgeted lifetime loan default rates for proprietary-school students is more than 40% vs. 12%⁽²⁾ overall.

(1) Source: SEC filings

(2) Source: U.S. Department of Education

(3) Source: College Board

The 'For Less Profit' Education Sector

The 'Old School' Mentality ('98-'08)

- The for-profit postsecondary schools seen as solution to overcrowded community colleges, key component in retraining US workforce.
- Industry trade groups, erstwhile executives (APOL, SLM) help rewrite regulatory framework: 90/10, recruiter compensation, distance/online learning, etc.
- Five largest proprietary schools by revenue increased cumulative enrollment by 379k from the beginning of 2004 to 630k at end of 2008⁽¹⁾, for a five-year CAGR of 11% compared to 1-2%⁽²⁾ growth at traditional colleges.

(1) Source: SEC filings for APOL, ESI, COCO, CECO, DV

(2) Source: U.S. Department of Education

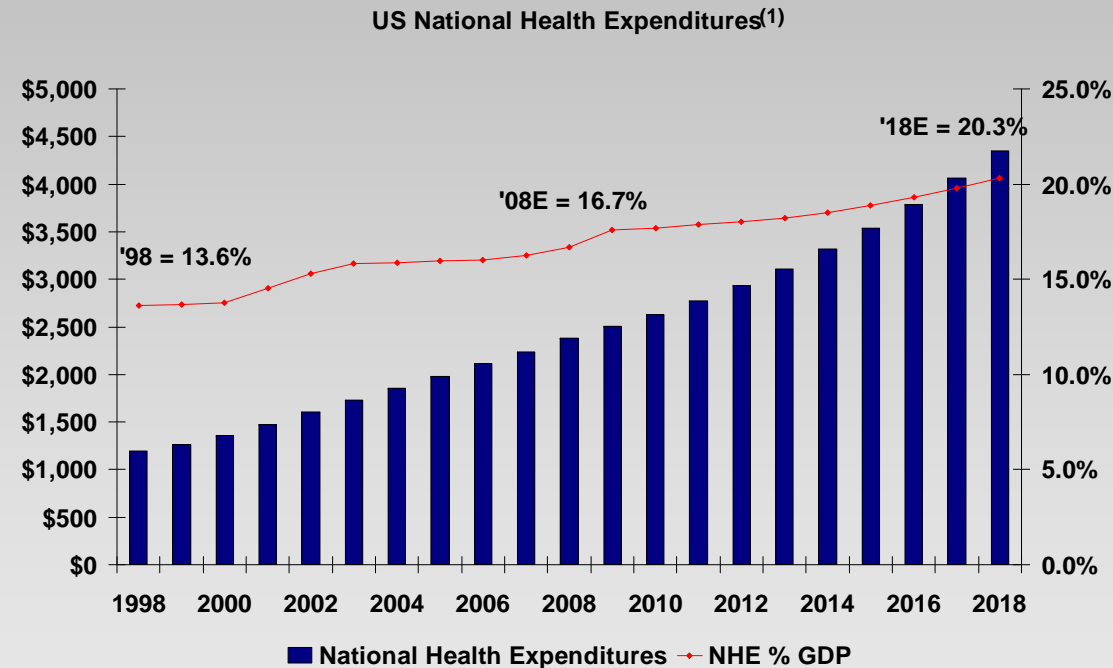
(3) Source: Bloomberg

The 'New School' Mentality ('09-)

- New Education Department places greater emphasis on community colleges, questioning the quality, cost and recruitment practices of for-profit schools.
- Administration, Capitol Hill staffers are re-examining rules on prop schools: rulemaking committee established this past week to renegotiate rules on incentive compensation, definition of a credit hour, job placement and other matters.
- Subsidized lending headed for extinction?
- Little margin for error: Eight publicly traded for-profit companies average P/E is 23.2x, a 56% premium to S&P 500's 14.9x P/E.⁽³⁾

Healthcare Cure Can't Wait

- Healthcare cost continues to outpace economic growth
 - Expenditures doubled over the past 10 years resulting in \$2.3 trillion of spending or ~17% of GDP⁽¹⁾
 - Over the next decade, forecasted spending to reach \$4.3 trillion or +20% of GDP⁽¹⁾
 - At projected rates, healthcare spending could approach \$30 trillion and make up ~40% of GDP by 2050
- The White House views reforming healthcare as a cornerstone of fixing the economy
 - Medicare to go bust by 2017 under current projections.⁽²⁾
 - Increasingly small/mid-sized companies are foregoing health insurance.
 - Economic downturn leading to more Americans without healthcare coverage.



(1) Source: Centers for Medicare and Medicaid Services

(2) Source: Social Security and Medicare Boards of Trustees

All that, and Universal Coverage too???

- 45mm Americans without health insurance
- Obama supports mandate for universal coverage with a goal of budget neutrality
- Individual mandate alone won't cover the increase in costs across the system
- Public plan of some form is likely to emerge
- Congress calling for greater governmental oversight, intervention and price controls
- Pressure on profits across the healthcare system going forward

The Squeeze is Coming

Obama isn't waiting for Congress to take actions to cut healthcare costs

- Holding industry's feet to the fire to come up with ways to take \$2 trillion in costs out of the system over the next 10 years.
- Healthcare Fraud Prevention and Enforcement Action Team (HEAT) combines forces of U.S. Department of Health and Human Services (HHS) and U.S. Department of Justice (DOJ) to tackle Medicare fraud
- Centers for Medicare and Medicaid Services (CMS) clawing back on past overpayments, as shown by recent Medicare Advantage rate cut

High margin areas for healthcare squeeze: U.S. Healthcare Industry Margins^{(1),(2)}

	Gross Margin (TTM)	Operating Margin (TTM)
Health Care Distributors	16.5%	4.3%
Health Care Equipment	59.0%	17.0%
Health Care Facilities	30.7%	10.8%
Health Care Services	35.2%	15.0%
Health Care Supplies	54.5%	16.2%
Health Care Technology	61.2%	9.5%
Life Sciences Tools & Services	54.2%	4.8%
Managed Health Care	19.0%	4.5%
Pharmaceuticals	71.8%	19.2%

(1) Source: Bloomberg

(2) Russell 3000 Healthcare Index, +\$500mm market cap

Lincare – In the Bull's-eye

- Home oxygen services sector has been an egregious example of Medicare abuse in the past
- Despite past challenges, competitive bidding is coming
 - CMS initially estimated 27% savings from competitive bidding
 - After a 9.5% across-the-board cut to Durable Medical Equipment (DME), there's still plenty for CMS to pursue
- Lincare's margins reflect past rate cuts, but still top the charts
- The timing of any future market share gains won't be enough to offset profit deterioration

Lincare's Continuing High Margins⁽¹⁾

	Gross Margin (TTM)	Operating Margin (TTM)
Lincare	75.0%	21.4%
PBM Avg,	7.6%	4.5%
Lab Avg.	41.5%	18.3%
Invacare	27.9%	5.1%
Resmed	59.1%	19.1%
Omnicare	25.6%	9.0%
PharMerica	14.8%	3.6%
Chemed	29.9%	11.9%
Amedisys	52.4%	13.4%

(1) Source: Bloomberg

Change We Can All Believe In: More Regulation & Lower Profits

The New Reality

- Healthcare, for-profit education and other industries reliant on governmental largess face a fundamentally different environment.
- Higher taxes for everyone in this room!

Opportunities to Offset Higher Taxes

- Go short these affected industries; AND...
- Give generously to the Ira W. Sohn Foundation

