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New Rec: Strayer Education (STRA: $171.09) March 15, 2009

Position: Sell **Target: $86**

	1Q09e	2Q09e	3Q09e	4Q09e	FY2009e	FY2010e
Rev ($Ms)	123.4	118.7	97.2	128.1	467.4	518.5
EPS ($)	1.98	1.62	0.49	1.63	5.70	5.16
Y/Y Growth	20.5%	8.0%	-41.2%	-5.0%	0.6%	-9.5%
PE	na	na	na	na	30.0	33.2
PSR	na	na	na	na	5.2	4.6
Consensus	1.97	1.81	1.02	2.19	6.99	8.63

Shares Out: 14.1M **Market Cap: $2.41B** **FYE: Dec. 31**

Concept:

1. Our research indicates that enrollment growth should slow. Consensus estimates are too high.
2. Recent DOE statistics lead us to conclude that Title IV applications for new enrollment per STRA campus are declining. This should be a leading indicator of slowing enrollment.

3. Prospective students are less willing to take on debt, corporate tuition reimbursement is being cut, rising unemployment is impacting the ability to pay and students are trading down to less expensive schools.
4. The quality of a Strayer education is low, reducing its appeal.

Summary: Strayer Education is a for-profit, post-secondary education provider serving working adults. The company operates 65 Strayer University campuses in 14 states and offers associate degrees (11% of its students), bachelor degrees (55%) and masters degrees (27%). 67% of its students are women and 71% are minorities. Courses are held at night, on the weekend and on line (live or on demand). 74% of Strayer's students major in business/economics/accounting and 17% are focused on IT. Undergraduate tuition runs about $1,500 per course or $14,000 per year for a full-time student.

STRA shares currently trade at 24x the "street's" consensus of $6.99 EPS for FY2009. This premium valuation appears to reflect the "street's" enthusiasm for Strayer's business and its future growth prospects. Bullish "street" analysts believe that the company's exposure to the current recession is limited, that its business is "counter-cyclical," that its "growth story is intact," and, importantly, that the recent momentum in enrollment growth is sustainable. We note that year over year enrollment growth has been 20%, 24% and 22%, for the past 3 quarters. As a result, the "street" is forecasting student enrollment growth of 21% y/y in FY2009, which, in turn, drives revenue growth of 25% y/y and EPS growth of 23% y/y, from $5.67 in FY2008 to $6.99 in FY2009.

However, based on conversations with our industry sources and data we have obtained from the US Department of Education, we think that Strayer faces significant challenges and headwinds that will pressure its enrollment growth rate and that should lead to disappointing financial results. In our view, the downside risk to Strayer's business is much greater than the "street" expects and significant stock price depreciation is likely.

According to our industry sources, which include recruiters, consultants and chief enrollment officers, it appears that the economy is, in fact, beginning to have a negative impact on the working adult education marketplace. According to one industry consultant, "it would be naïve to think the economic uncertainty is not going to put significant pressure on mid- to lower-tier institutions." First, the current economic turmoil and related workplace uncertainty is frightening potential students from taking out student loans to pay for their education, thereby, accumulating a significant amount of debt. Prospective students are "too stressed," "more scared to take on debt at this time" and, despite their best efforts, enrollment officers "can't convince them" to enroll using student loans. This trend seems to correspond with recent economic news that consumers are de-leveraging their personal balance sheets. We note that about 66% of Strayer's students take part in the US government Title IV student aid program, consisting primarily of loans.

Second, corporations are cutting tuition reimbursement benefits. The Director of Career Services for one university told us, "the companies offering tuition reimbursement assistance are all evaporating. Tuition assistance benefits come and go like the flavor of the month." A Strayer recruiter in Tennessee told us that she has seen students that "were planning on going but since their company cut it [tuition reimbursement], they don't want to start." According to management, roughly 20%-25% of Strayer's students receive tuition reimbursement from their employers. We note that several surveys of human resource executives indicate that approximately 10%-20% of companies plan to cut these benefits.

Third, approximately 10% of Strayer's students are self-pay or family-pay, and the rising unemployment and economic uncertainty is impacting students' and prospective students' ability and desire to lay out several thousands of dollars. Additionally, the dean of Babson College graduate schools was recently quoted, "People are saying 'I can't afford to take time off from work.' They're afraid they might lose their jobs. And because of corporate downsizing, they have more work than ever, so they have less time for their studies." Fourth, students are trading down to lower-priced educational alternatives. Community colleges and state-run universities offer similar degrees as Strayer but often at a price that is significantly lower. According to one industry executive, "students appear to be price shopping." These issues are discussed in greater detail below.

Importantly, the above problems, which we learned of anecdotally, appear to be supported by data that we obtained from the Department of Education (DOE). Students wanting to use Title IV government financing to pay for their education must apply using a Free Applications for Federal Student Aid (FAFSA) form. According to the DOE, the number of FAFSA applications it received for "new" students wanting to attend Strayer University increased by just 2.6% y/y in calendar year 2008 versus calendar year 2007. This growth rate is down significantly from the 23.8% y/y growth reported in calendar 2007. (We note that the applications received in calendar year 2008 are for enrollment in the academic year 2008-2009 (July 1, 2008 to June 30, 2009)). While applications for new Strayer students for academic year 2008-2009 barely increased over the number of applications for academic year 2007-2008, the number of Strayer campuses to which they were applying increased by roughly 18%. Therefore, we conclude that the number of "new applications per campus" declined by -13% y/y in 2008.

Given this data, the question can be asked how has Strayer been able to increase its total enrollment by more than 20% y/y in the past three quarters? Interestingly, the DOE data shows that “renewal” applications for students that used title IV funds to pay in the 2007-2008 academic year increased by 75.6% y/y in 2008, for payment in the 2008-2009 academic year. This compares to 18.7% y/y renewal growth reported in 2007. This large increase appears to have offset the deceleration in new enrollment.

Better retention causes higher renewals. Management recently stated that its retention rate increased throughout 2008 and that it has “reached a very high level of efficiency with regard to retention.” Management hopes to “keep it at this level” and doesn’t expect it to increase significantly in the future. The director of adult enrollment for one Strayer competitor thinks that there is a dichotomy in the market between those students that are already enrolled and prospective students. Prospective students, as we mentioned above, are very hesitant to take on new debt and obligations in today’s economy and are, therefore, less likely to enroll. Existing students, on the other hand, are more likely to stay enrolled in the current economic environment. “Once they’re in and starting, and utilizing their Title IV funds” and are “committed to incurring debt,” then they are more likely to remain in the program. Lax enforcement of its education standards, reported to us by Strayer personnel, may also be contributing to Strayer’s increased retention rate and renewals, as we discuss below.

The problem for Strayer is that students cannot renew forever. In fact, according to management, a typical student attends Strayer for just two years. So while renewals may be positively affected by the company's retention rate in the short-term, ultimately, the number of renewals will be driven by the number of new enrollees. We think that the substantial slowdown in Title IV applications for new enrollment is an early warning sign and a leading indicator that Strayer's future enrollment growth is likely to slow.

Strayer is now using unusual promotions to enroll students. We have learned via our calls to Strayer campuses that the company is “providing a $300 book voucher and waiving the application fee [$50]” to those who enroll for the spring quarter, beginning April 13. This promotion is a “special incentive” and “special enticement,” according to the recruiters, to take into account the current state of the economy. None of the recruiters were aware of this promotion having occurred in the past.

Exacerbating the economic-related problems facing Strayer is the longer-term issue that a degree from Strayer University probably means very little in the workplace and that the quality of the Strayer education is low. According to the

National Center for Education Statistics (part of the DOE), Strayer's graduation rate for a full-time bachelors degree is just 8%. Granted, a small percentage of Strayer's students actually fall into the criteria for this data (described below), yet, we still think the data is telling. According to multiple sources, Strayer's "primary concern" is getting a prospective student enrolled, "regardless of whether you are ready for it or can't do it." Education of the student is secondary to getting him/her in the door.

The "street" is very bullish on STRA. In fact, 10 out of 14 analysts have buy/outperform ratings, according to Bloomberg. The "street" consensus for revenue growth is 25.1% y/y in FY2009 and 21.7% y/y in FY2010. FY2009 revenue is driven by the "street's" expectation for approximately 21% y/y growth in student enrollment and 4% y/y growth in revenue per student, due to higher tuition rates.

Based on our industry surveys and analysis of the company's Title IV application data, we forecast Strayer's total revenues to increase by 18.0% y/y and 10.9% y/y in FY2009 and FY2010, respectively. Our FY2009 revenue growth forecast is driven by a 14% y/y increase in enrollment and 4% y/y growth in revenue per student. We note that Strayer has already reported 1Q09 enrollment growth of 22% y/y, which benefits its results for the full year, FY2009. We estimate 11 new campuses in FY2009 (18% y/y growth), per management's guidance. This is offset by our forecast for a –10% y/y decline in students per campus at its mature campuses (open more than 3 years) and a –10% y/y reduction in the rate at which new campuses ramp up their enrollment. We model these declines in per campus enrollment to begin in 3Q09, at the start of the 2008-2009 academic year.

We model gross margins of 66.9% and 64.7% in FY2009 and FY2010, respectively. This compares to the "street" estimates of 67.2% in FY2009 and 67.3% in FY2010. We forecast FY2009 operating margins at 28.0% versus the "street's" 32.2% estimate. For FY2010, we model operating margins of 22.7%, significantly below the "street's" 32.7% forecast. We think lower than expected revenue growth will result in negative leverage on the company's fixed cost campus and educational expenses, as we discuss below. In fact, management noted recently that 20% y/y enrollment growth is necessary to maintain flat operating margins in FY2009 versus FY2008. Our bottom line EPS estimate is $5.70 for FY2009 (a 1% y/y increase) and $5.16 for FY2010 (a –9% y/y decline). Comparatively, the "street" expects EPS to grow 23% y/y to $6.99 in FY2009 and to grow 24% y/y in FY2010 to $8.63.

Our price target is $86. We think that Strayer is likely to experience a significant earnings shortfall versus current expectations in FY2009 and FY2010. In addition to the lower than expected earnings, a contraction of its PE multiple could be severe, in our opinion, as investors come to expect a lower growth rate and/or negative growth going forward. Our price target is based on a 15x PE multiple on our FY2009 EPS estimate of $5.70. This valuation is a 20% premium to the market, which may prove to be too high if our thesis proves correct and earnings fall in FY2010 as we forecast.

Insider selling of Strayer shares among officers and directors has been modest in the past month. However, in December, CEO Robert Silberman sold 131,478 shares (95% of his then holdings) at a price of $228.40. Mr. Silberman sold these shares on the very first day that they became 100% vested.

Background:

Strayer Education Inc., based in Arlington, VA, is a for-profit, post-secondary education provider serving working adults. The company operates 65 campuses in 14 states and has 46,000 students enrolled in its current winter term. It operates as Strayer University.

The company began operations in 1892 with the founding of Strayer's Business College of Baltimore City by Dr. Irving Strayer. Over the next hundred years or so, the company primarily offered business degrees at just a few campuses. In 1969, Strayer received its first license to grant bachelor degrees to its students, and in 1987 it was authorized to award masters degrees. With the acquisition of the company by Mr. Ron Bailey in 1989, the company began a more rapid expansion of Strayer campuses. By 1996, Strayer was operating 8 campuses and STRA went public that year. In 2000, the company completed a recapitalization and brought in a new management team, including the current CEO Mr. Robert Silberman. Strayer University is accredited through 2017 by the Middle States Commission on Higher Education, one of the US's six regional accrediting agencies.

Strayer's campuses are primarily located on the East Coast, as shown in Table 1. A typical campus is a leased space of roughly 20,000 square feet, with 15 classrooms that can seat 20 students each. A campus generally has two or three computer labs. The total capacity of each campus is about 1,000 students. Strayer offers classes at night, on the weekend and online. Online classes can be taken either live (synchronous) or on-demand (asynchronous). 72% of students take at least one course online. The University operates on a quarter system rather than by semester and each quarter is approximately 11 weeks long.

Table 1
Location of Strayer Campuses
As of Spring 2009 Quarter

State	# of Campuses
Virginia	11
Florida	9
Georgia	8
North Carolina	7
Pennsylvania	7
Maryland	5
Tennessee	4
South Carolina	3
Alabama	2
Kentucky	2
New Jersey	2
Washington DC	2
Delaware	1
West Virginia	1
Utah	1
Total	65

Source: Company Info

Strayer's student population is comprised mainly of working adults with an average age of 35 years. 67% of its students are women, 71% are minorities, 3% are located internationally and 3% are active military personnel. 74% of Strayer's students major in business/economics/accounting and 17% are focused on IT. As shown in Table 2, the majority of Strayer's students are seeking a bachelor degree. According to the company, 82% of its students are part-time (take less than three courses per quarter) and the average student takes roughly two courses per quarter. A substantial portion of Strayer's students transfer credits from another institution.

Table 2
Degrees and Tuition for Strayer Students
As of Spring 2009 Quarter

Degree	% of Students	Tuition per Course for Full-Time Student	Tuition per Course for Part-Time Student
Bachelor Degree	55%	$1,435	$1,510
Masters Degree	27%	$1,945	$1,945
Associate Degree	11%	$1,435	$1,510
Undeclared	5%	na*	na*
Diploma/Certificate	2%	$1,435	$1,510

* Depends on which course student is taking

Source: Company Presentation

Table 2 also breaks down the tuition expense for Strayer students. A full-time student completing his/her bachelor degree in four years would pay roughly $57,000 over this time period. In 4Q08, 66% of Strayer's students paid for their tuition using Title IV financial aid. Corporate tuition reimbursement paid for about 20%-25% of students' tuition. The remainder is self-pay or family-pay. In FY2007, the company noted that 3% of students used private loans, but this market dried up in 2008. Strayer breaks its student enrollment into three categories: new campuses (17% of total enrollment), mature campuses (73%) and global online (11%), as shown it Table 3.

Table 3
Strayer's Student Enrollment by Campus For the
Winter 2009 Quarter

	# of Students
New Campuses (25 in operation)	
Classroom	3,144
Online	4,528
Total New Campus Students	7,672
Mature Campuses (37 in operation)	
Classroom	14,731
Online	18,425
Total Mature Campus Students	33,156
Global Online	4,869
Total University Enrollment	45,697

Source: Company Press Release

A. New campuses are defined as those that are open for three or fewer years. There are currently 25 new campuses in the Strayer network. According to management, it takes a new campus approximately 6 to 7 years to ramp up to full capacity. The notional model is for a new campus to gain 100 to 150 new students each year until it reaches 1,000 students, and then levels out. In the first year of operation, a typical new campus generates $200,000 in revenue and incurs $1.1 million in operating costs. New campuses generally begin to turn a profit after 6 quarters.

B. Mature campuses are defined as those open for more than three years. There are currently 37 mature campuses in operation.

C. Global online students are those enrollees taking courses solely online, and who do not live in the geographic area surrounding a physical campus. About 1/4 of global online students are located internationally.

Discussion:

1. Despite today's recessionary environment, bullish "street" analysts remain upbeat about Strayer's business fundamentals and believe that the company's recent momentum in enrollment, revenue and earnings growth is sustainable. In fact, the "street" is forecasting FY2009 student enrollment growth of 21% y/y, revenue growth of 25% y/y and EPS growth of 23% y/y, from $5.67 in FY2008 to $6.99 in FY2009. This optimism appears to reflect the "street's" notion that Strayer's business is "counter-cyclical" and that its exposure to the economy is limited. We think, on the other hand, that Strayer faces significant challenges that will pressure enrollment growth, and that should lead to disappointing financial results relative to the "street's" expectations.

2. Based on our conversations with industry insiders, it is our view that the economy is beginning to have a negative impact on the working adult education industry. One university enrollment officer is "starting to see some changes and trends" caused by the recession, and adult enrollment at his university is being affected. Specifically, our sources tell us that 1) prospective students are reluctant to take on debt, 2) corporate tuition reimbursement is being cut, 3) rising unemployment is impacting students' ability to pay and 4) students are trading down to less expensive schools.

The current economic turmoil and related workplace uncertainty is frightening potential students from accumulating debt in order to attend school.

An enrollment officer told us that a "sizeable percentage" of his potential applicants do "not want to take on debt." Another source has seen students lose tuition reimbursement and "80% say no!" when asked if they want to offset the loss with a student loan. These decisions are driven mainly by "fear in the economy" and the desire for consumers to de-lever their personal balance sheets.

A. This is important because, in 4Q08, 66% of Strayer's students participated in the US government Title IV financial aid program, primarily student loans. And according to its 10-K, 72% of Strayer's revenue is derived from Title IV funds. If prospective or existing Strayer students are "losing tuition reimbursement or their means for income," as one source stated, then student loans are the only remaining financing option. And if students shy away from student loans, enrollment is likely to be impacted.

According to Strayer's 2007 10-K, about 3% of Strayer's revenue came from students using private loans. This market tightened up considerably in 2008 and, as a result, these students must generally use other funding sources.

B. Corporations are cutting their tuition reimbursement benefits. Companies are seeking ways to save money and are instituting cost cutting strategies. A common strategy, according to industry experts, is to cut back on employee benefits such as tuition reimbursement. "A lot of companies are definitely scaling back," a Florida recruiter told us. According to management, roughly 20%-25% of Strayer's revenue comes from tuition reimbursement.

"Banks have slowed down on tuition reimbursement and the hotel industry… Sheraton and ITT suspended this quarter their tuition reimbursement," according to one Strayer recruiter. "I am aware that UPS recently reduced the amount of assistance that they provide employees," noted another. A third Strayer recruiter told us that Metlife has "eliminated tuition assistance." We also note that SprintNextel recently announced that it was suspending its tuition reimbursement program.

A university enrollment advisor told us that Raymond James "recently tightened their policy in terms of who they approve to receive tuition reimbursement. Same goes for Honeywell." The director of enrollment for a large graduate school recently stated "we've had indications from evening candidates that their tuition reimbursement had been either scaled back or has disappeared."

Interestingly, not only are corporations cutting their programs but employees may choose to voluntarily avoid participation. According to an industry advisory firm, "during the past recessions, corporations have witnessed a –20% decline in employees participating in tuition reimbursement programs. This time, due to the state of the economy, the decline may be much worse. I think it will be unprecedented."

Several surveys, conducted by HR experts, indicate cuts in tuition reimbursement benefits. A January survey (performed by the firm Challenger, Gray & Christmas) of 100 HR executives found that 11% of companies have cut back on tuition reimbursement in an effort to save costs. According to a Watson Wyatt survey of 245 large US companies, 18% intend to reduce or eliminate other employee programs such as tuition reimbursement. Lastly, a survey by the Society for Human Resource Management found that 16% of companies plan to cut their tuition reimbursement programs.

C. Approximately 10% of Strayer's students are self-pay or family-pay and, according to our sources, the rising unemployment and economic uncertainty is impacting students' and prospective students' ability and desire to lay out several thousands of dollars.

For example, one enrollment officer in New Jersey told us that Verizon Wireless has recently laid off local retail employees. Some of these workers didn't have the finances to pay tuition, didn't want to accumulate debt and, therefore, opted out of the university's program.

Additionally, corporate layoffs have "affected the work load" of employees that remain employed, and these students no longer have the time to continue in their program. One enrollment officer for a large university has seen a drop in enrollment for their degree programs because of the "greater time commitment" required. He is seeing more students choose a non-degree program in order to learn a new skill in just 6 months to a year.

D. Students are trading down to lower-priced educational alternatives. Community colleges and state-run universities offer similar degrees as Strayer but often at a price that is significantly lower. For instance, a college such as University of Central Florida (UCF) offers in-state tuition of just $3,947 for a standard annual course load. This compares to roughly $14,000 for Strayer. The UCF campus is just 9 miles away from Strayer's Maitland, FL campus.

The President of the National Center for Public Policy and Higher Education was recently quoted as saying, "the country is in the process of reconsidering the easy accumulation of debt for consumer things, and it may well be that that will be a factor that tilts people toward public institutions because of the cheaper sticker price.” According to a report by Inside Higher Ed, “some community colleges are waiving tuition for their local jobless.”

The CFO of American Public Education (APEI), who was also the former CFO at Strayer, recently spoke about his company. “At the undergrad level, total tuition is $30,000 or $7,500 per year. This is cheaper than most public universities and certainly cheaper than [for-profit] competitors. At the grad level, the comparison is even more stark. Tuition is just $9,850 for an MBA degree as compared to $20,000 for the competition. APEI teaches the same 12 courses as Strayer.” “Competition has historically raised tuition costs every year. APEI hasn’t done so since 2001. I believe the competition, as a result, has priced itself out of the market.”

3. According to data we obtained from the US Department of Education, the number of Title IV FAFSA applications it received for “new” students wanting to attend Strayer University increased by just 2.6% y/y in calendar year 2008 versus calendar year 2007. This growth rate is down significantly from the 23.8% y/y growth reported in calendar 2007, and, in our opinion, is an early warning sign and a leading indicator that Strayer's future enrollment growth is likely to slow.

Students wanting to use Title IV government financing to pay for their education must apply using a Free Applications for Federal Student Aid (FAFSA) form. Table 4 shows the number of FAFSA applications that the DOE received for students wanting to attend Strayer, as published by the DOE on January 9, 2009. We note that the applications received in calendar year 2008 are for enrollment in the academic year 2008-2009 (July 1, 2008 to June 30, 2009). Interestingly, while applications for new Strayer students for academic year 2008-2009 barely increased over the number of applications for academic year 2007-2008, the number of Strayer campuses to which they were applying increased by roughly 18%. From this, we conclude that the number of “new applications per campus” declined by -13% y/y in 2008.

Table 4
Number of Title IV FAFSA Applications Received by the DOE
For Students Wanting to Enroll at Strayer

Type of Application	Calendar 2006	Calendar 2007	Calendar 2008
New ("Original")	16,749	20,728	21,266
Renewal	9,393	11,145	19,572
Total	26,144	31,873	40,838

Note: Applications received in calendar 2008 are for enrollment in academic year 2008-2009 (7/1/08-6/30/09). Similar for 2006, 2007.

Source: Department of Education

Given this data, how has Strayer been able to increase its total enrollment by more than 20% y/y in the past three quarters? As Table 4 shows, "renewal" applications for students that used title IV funds to pay in the 2007-2008 academic year increased by 75.6% y/y in 2008, for payment in the 2008-2009 academic year. This large increase appears to have offset the deceleration in new enrollment. According to our sources, greater renewals are mainly a result of improved retention, and retention tends to increase in times of economic uncertainty.

Additionally, after speaking with several Strayer recruiters, it is our view that the company uses lax educational standards to keep its students enrolled, and this may benefit its retention rate. According to one recruiter, "it could take weeks for them [instructors] to get in touch with you" if you are not turning in assignments. We note that each course runs for only 11 weeks. "It isn't in our best interest to fail a student…our goal is to get you through" the program, another recruiter told us. And another said "If you come to Strayer, we are not going to fail you." One recruiter told us of a student who "wasn't able to post assignments for several weeks, she notified the instructor and the instructor allowed her to stay enrolled. You shouldn't go weeks on end without at least posting something to the class discussion board. Out motto is 'we want our students to succeed.' So, instructors will work with a student but the student should keep the instructor informed of their situation."

The bottom line is that students cannot renew forever. Eventually they graduate or drop out. In fact, the average Strayer student is enrolled for just 2 years. So, while renewals may be positively affected by the company's retention rate in the short-term, ultimately, the number of renewals will be driven by the number of new enrollees.

4. Exacerbating the economic-related problems facing Strayer is the longer-term issue related to the quality of a Strayer education. According to multiple sources, education of the student is secondary to getting him/her in the door.

According to the National Center for Education Statistics (part of the DOE), Strayer's graduation rate is just 8% for full-time bachelor degree (3 courses per quarter) seeking students that are also first-time college goers. While only a small percentage of Strayer's students actually fall into the criteria for this data, we still think the data is telling. In fact, the national average is 57%. We also note that 2,223 out of Strayer's 2,407 total instructors/professors (92%) are part-time.

According the Dean on Adult Enrollment at a university with 3,000 students, Strayer is "all about getting you in," to the detriment of its educational standards.

Interestingly, we received an email from a Strayer recruiter just minutes after having spoken with him by phone. The subject line read "Strayer University Understands Today's Difficult Times," and the email reads as if it were perhaps drafted by Strayer's corporate office. Near the end of the email, it states "Please note that current levels of Financial Aid available to new and continuing students have never been higher. This is allowing nearly all of our students to attend Strayer University with no up-front "out of pocket" expenses to them whatsoever. But, in view of the worsening economy, there is a great deal of concern as to how long these levels of Federal Funding support will be continue. As a result, we are advising all individuals considering using Financial Aid to help them go to school do so sooner rather than later if at all possible." It appears that Strayer is using scare tactics to enroll new students. We wonder, is this out of desperation for enrollment growth or part of the normal recruiting strategy for Strayer?

Another Strayer recruiter told us, as part of his sales pitch, "an MBA here holds the same clout as an MBA from Princeton." We did not want to tell the recruiter that Princeton doesn't even offer an MBA program.

5. Strayer spent $76M on sales and marketing in FY2008, 19.2% of total revenue. This compares to Strayer's spend on instructional and educational costs of $130M, 33.0% of revenue.

The potential problem with these numbers comes from the fact that Strayer derives 72% of its revenue from Title IV government funds, and only 1/3 of these funds is actually going towards the education of Strayer's students. A significant portion (19%) is invested in Strayer's advertising and recruiters and an even greater amount is reported as operating profit (32%) for Strayer's shareholders.

This is a remarkably high operating profit that might raise eyebrows. Not to mention executive compensation.

We wonder, as do many others in the education industry, will the US government will begin to crack down on for-profit educators? Does it think it is appropriate for so little of the government's money to go towards education and so much towards sales and marketing and corporate profits? We've already seen that the Obama administration is willing to make big changes in the education industry, such as the proposal to eliminate privately-funded government loans (which, by the way, we do not expect to have any meaningful impact on Strayer).

6. Several of Strayer's recruiters offered to waive the $50 application fee and provide us with a $300 book voucher, if we were to enroll for the spring term, which begins April 13. This promotion is new, according to the recruiters, and could be a sign that the company's spring enrollment is tracking below plan.

Hypothetically, if a prospective student were to accept the company's promotional offer and sign up for just one undergrad class, he/she would pay $1,510 in tuition and that's it. Without the promotion, a new student would pay $1,510, plus $250-$300 for books and a $50 application fee. The total would be $1,810-$1,860. Therefore, we calculate that the promotion equates to an 18% discount, under this scenario.

7. Increasing bad debt expense continues to be a problem for Strayer. In 2002, bad debt was just 1.5% of total revenue. In 4Q08, bad debt had risen to 3.8% of revenue (up from 3.6% in 4Q07). The problem is that Strayer's management gives discretion to its local campus executives to enroll students even if they are not able to pay for the class upfront. It appears that local executives have increasingly taken advantage of this discretion. As a result, accounts receivables have grown significantly faster than revenues and DSO has risen from 74 days at year-end FY2000 to 125 days at year-end FY2008. If a student drops out, can't pay or chooses to not pay, the receivable may never be collected. Management admits "it takes a one quarter risk" with these students.

According to one industry enrollment officer, bad debt may also result "if tuition rates exceed Title IV loan limits," resulting in a funding "shortfall." For example, the government's limit on Title IV loans to Freshman is currently $9,500 per academic year. However, a full-time Freshman at Strayer might take 12 courses per year at a tuition rate of $1,435 per course. The total cost would be $17,220, far in excess of the student's loan amount. And this does not include roughly $3,000 in additional costs for books ($250-$300 per course). The student is responsible for paying Strayer the shortfall in his/her funding, and his/her ability to pay may be impacted by the current recession, according to our source. Government loan limits for undergraduates increased by $2,000 on July 1, 2008, as shown in Table 5. One might expect that the higher loan limits would have benefited Strayer's bad debt expense in 2H08, but its expense increased year over year, as a % of revenue.

Table 5
2008 Increase in Title IV Annual Loan Limits
Per Independent Student

	Prior to July 1, 2008	Effective July 1, 2008
Undergraduate Students		
Freshman	$7,500	$9,500
Sophomore	$8,500	$10,500
Junior or Senior	$10,500	$12,500
Graduate Student	$20,500	$20,500

Source: Department of Education

One can see how such a discretionary policy to allow students to enroll without an upfront payment could impact the company's enrollment statistics. For instance, in 4Q08, accounts receivables grew by 31% y/y, as compared to a 26% y/y growth in the company's unearned tuition liability, which is the dollar amount of education owed to enrolled students. This indicates that a greater number of enrollees didn't pay up front versus a year prior. Had the company's standard for upfront payments remained the same, accounts receivable would have grown at roughly the same rate as unearned tuition, receivables would have been $5.8M less than reported at 12/31/08 and enrollment would have been 2,262 less than reported in 1Q09.

8. Another risk to Strayer's revenue growth rate is the possibility that its students could decide to take fewer classes, resulting in lower than expected revenue per student. Strayer management stated on its last conference call that it is not seeing such a trend. However, two of its competitors, Capella and DeVry, both recognized that such a phenomenon was occurring.

Capella's management stated "our learners are taking slightly fewer courses per quarter… due to increased job pressures and demands." DeVry management noted that the recession has resulted in "a little bit of actual degradation" in its students' course loads, particularly for more expensive courses.

9. Recent Results

Strayer reported 28.2% y/y revenue growth in 4Q08. This was driven by a 23.5% y/y increase in enrollment to 44,564 students. Higher tuition contributed 4.7 percentage points to the top-line growth rate. We note that Strayer consistently raises its tuition prices by about 5% on January 1 of each new year. The number of Strayer University campuses increased 18% y/y, from 51 in 4Q07 to 60 in 4Q08.

Table 6
Recent Results

	4Q07	4Q08	Y/Y Growth	4Q08 Margin
Campuses	51	60	17.6%	
Enrollment	36,082	44,564	23.5%	
Revenue	$89,131	$114,281	28.2%	
Gross Profit	$59,494	$78,544	32.0%	68.7%
Operating Profit	$29,201	$39,435	35.0%	34.5%
Diluted EPS	$1.34	$1.71	27.6%	

Source: Company Info

4Q08 gross margins increased by 200 basis points year over year, from 66.7% in 4Q07 to 68.7% in 4Q08. This improvement was driven by the strong enrollment growth reported in the quarter. We note that the company's COGS consists primarily of instructional costs, such as faculty salaries and rent. It doesn't cost Strayer much more to teach a class of 20 students versus a class of 15, for example, because all it needs is an instructor and a room. Therefore, higher enrollment per campus typically benefits the company's gross margin, as it did in Q4.

Benefiting from the year over year improvement in gross margin, the company's 4Q08 operating margin increased to 34.5%, up from 32.7% in 4Q07. Operating costs (sales & promotion and general & administration), as a % of revenue, increased from 34.0% in 4Q07 to 34.2% in 4Q08. As noted previously, the company's bad debt expense increased from 3.6% of total revenue in 4Q07 to 3.8% in 4Q08. 4Q08 EPS was reported at $1.71. This compares to $1.34 in 4Q07.

As is management's custom, it reported 1Q09 enrollment figures along with 4Q08 financial results. Strayer's winter term (January thru March) enrollment increased 22.4% y/y, from 37,323 in 1Q08 to 45,697 in 1Q09.

Management's guidance for 1Q09 financial results calls for revenue growth of 25%-26% y/y and EPS of $1.96 to $1.98. This compared to the then "street" consensus of $1.99 EPS. The disappointing guidance was due mainly to lower than expected investment income due to falling yields on its cash balance, a higher than expected tax rate and management's expectation for flat operating margins year over year due primarily to its greater than expected investment in new campuses and its new global online operating center that is opening this summer in Salt Lake City, UT. STRA shares, which were trading at $226, or 32x PE on consensus EPS, traded down sharply in response to slightly the lower than expected guidance.

10. Despite the current economic environment, "street" models continue to reflect strong growth expectations for Strayer in FY2009 and FY2010. The "street" is forecasting revenue to grow 25.1% y/y in FY2009 and 21.7% y/y in FY2010. FY2009 revenue growth is driven by the "street's" expectation for approximately 21% y/y growth in student enrollment and 4% y/y growth in revenue per student, due to higher tuition rates.

Comparatively, we forecast Strayer's total revenues to increase by 18.0% y/y and 10.9% y/y in FY2009 and FY2010, respectively. Our FY2009 revenue growth forecast is driven by a 14% y/y increase in student enrollment and 4% y/y growth in revenue per student. We note that Strayer has already reported 1Q09 enrollment growth of 22% y/y, which benefits its results for the full year, FY2009. We estimate 11 new campuses in FY2009 (18% y/y growth), per management's guidance. For new campuses (open for 3 years or less), which are still in the process of building enrollment, we model a –10% y/y reduction in the rate at which enrollment ramps up beginning in 3Q09, when the 2008-2009 academic year begins. Specifically, rather than each new campus adding 180 students per year, we are forecasting 162. For mature campuses (open for more than 3 years), we model a –10% y/y decline in students per campus beginning in 3Q09.

The "street" is forecasting gross and operating margins of 67.2% and 32.2% in FY2009, and 67.3% and 32.7% in FY2010, respectively. We model gross margins of 66.9% and operating margins of 28.0% for FY2009. In FY2010, we estimate gross and operating margins of 64.7% and 22.7%, respectively.

Consensus EPS estimates are $6.99 for FY2009 and $8.63 for FY2010. This compares to our EPS estimates of $5.70 and $5.16 for the full year FY2009 and FY2010, respectively.

We model FY2009 free cash flow of $55M, or $3.90 per share, as management expects capital expenditures to be 7%-9% of total revenue due to the rapid build out of new campuses and the new online operations center.

11. We initiate with a price target of $86. We think that a great deal of future growth is currently priced into STRA shares, as it is trading at 24x PE on FY2009

consensus estimates. "Street" analysts believe STRA should be regarded as a "defensive" stock that will outperform in tough economic times. We, on the other hand, think that the company faces significant challenges and headwinds, that its recent growth is unsustainable and that significant earnings disappointments will occur.

Our price target is based on a 15x PE multiple on our FY2009 EPS estimate of $5.70. This valuation is a 20% premium to the market, which may prove to be too high if our thesis proves correct and earnings fall in FY2010 as we forecast.

12. There has been a modest amount of insider selling of STRA shares by officers and directors in the past month. In December, CEO Robert Silberman sold 131,478 shares (95% of his then holdings) at a price of $228.40. Interestingly, Mr. Silberman sold these shares on the very first day on which they became 100% vested.

13. Financial Models

Income Statement ($Ms)	FY2007	FY2008	FY2009e	FY2010e
Total Revenue	318.0	396.3	467.4	518.5
Instructional/Educational Expense	108.9	130.8	154.8	183.3
Gross Profit	209.2	265.4	312.6	335.3
Selling/Promotion Expense	60.8	76.2	96.6	112.7
General/Administration Expense	50.8	62.4	85.0	105.0
Operating Income	97.6	126.9	131.0	117.6
Interest/Other Income	6.5	4.5	1.5	2.3
Net Income Before Taxes	104.1	131.4	132.5	119.9
Provision for Income Taxes	39.1	50.6	52.1	47.1
Net Income	64.9	80.8	80.4	72.8
Basic Weighted Average Shares	14.2	14.0	13.6	13.6
Basic EPS	4.56	5.77	5.94	5.37
Diluted Weighted Average Shares	14.5	14.2	14.1	14.1
Diluted EPS	4.47	5.67	5.70	5.16

Y/Y % Change	FY2007	FY2008	FY2009e	FY2010e
Total Revenue	20.6%	24.6%	18.0%	10.9%
Instructional/Educational Expense	19.5%	20.2%	18.3%	18.4%
Gross Profit	21.2%	26.9%	17.8%	7.3%
Selling/Promotion Expense	16.2%	25.3%	26.9%	16.6%
General/Administration Expense	24.9%	22.8%	36.2%	23.5%
Operating Income	22.7%	30.0%	3.3%	-10.2%
Interest/Other Income	43.2%	-30.4%	-66.9%	53.3%
Net Income Before Taxes	23.8%	26.3%	0.9%	-9.5%
Provision for Income Taxes	23.1%	29.3%	3.0%	-9.5%
Net Income	24.1%	24.4%	-0.5%	-9.5%
Basic Weighted Average Shares	0.4%	-1.6%	-3.3%	0.0%
Basic EPS	23.6%	26.5%	2.9%	-9.5%
Diluted Weighted Average Shares	0.2%	-1.9%	-1.0%	0.0%
Diluted EPS	23.8%	26.8%	0.6%	-9.5%

% of Revenue	FY2007	FY2008	FY2009e	FY2010e
Total Revenue	100.0%	100.0%	100.0%	100.0%
Instructional/Educational Expense	34.2%	33.0%	33.1%	35.3%
Gross Profit	65.8%	67.0%	66.9%	64.7%
Selling/Promotion Expense	19.1%	19.2%	20.7%	21.7%
General/Administration Expense	16.0%	15.8%	18.2%	20.2%
Operating Income	30.7%	32.0%	28.0%	22.7%
Interest/Other Income	2.0%	1.1%	0.3%	0.4%
Net Income Before Taxes	32.7%	33.2%	28.3%	23.1%
Provision for Income Taxes	12.3%	12.8%	11.1%	9.1%
Net Income	20.4%	20.4%	17.2%	14.0%

Income Statement ($Ms)	1Q08	2Q08	3Q08	4Q08	1Q09e	2Q09e	3Q09e	4Q09e
Total Revenue	97.1	97.9	87.0	114.3	123.4	118.7	97.2	128.1
Instructional/Educational Expense	31.6	32.9	30.6	35.7	37.8	39.1	36.4	41.5
Gross Profit	65.4	65.0	56.4	78.5	85.6	79.7	60.8	86.6
Selling/Promotion Expense	15.1	16.7	23.0	21.4	20.0	21.5	28.9	26.3
General/Administration Expense	14.8	14.7	15.2	17.8	20.0	21.0	21.0	23.0
Operating Income	35.6	33.6	18.2	39.4	45.6	37.2	10.9	37.3
Interest/Other Income	2.0	0.8	0.9	0.8	0.3	0.4	0.4	0.5
Net Income Before Taxes	37.6	34.4	19.2	40.2	45.9	37.6	11.3	37.8
Provision for Income Taxes	14.1	13.1	7.4	16.0	18.0	14.8	4.4	14.8
Net Income	23.5	21.3	11.8	24.2	27.9	22.8	6.8	22.9
Basic Weighted Average Shares	14.1	14.0	14.0	13.6	13.6	13.6	13.6	13.6
Basic EPS	1.67	1.52	0.84	1.78	2.06	1.68	0.51	1.69
Diluted Weighted Average Shares	14.3	14.3	14.2	14.1	14.1	14.1	14.1	14.1
Diluted EPS	1.64	1.50	0.83	1.71	1.98	1.62	0.49	1.63

Y/Y % Change	1Q08	2Q08	3Q08	4Q08	1Q09e	2Q09e	3Q09e	4Q09e
Total Revenue	21.1%	24.2%	24.6%	28.2%	27.1%	21.2%	11.8%	12.1%
Instructional/Educational Expense	20.7%	23.1%	16.4%	20.6%	19.3%	18.7%	19.3%	16.2%
Gross Profit	21.2%	24.7%	29.5%	32.0%	30.8%	22.5%	7.7%	10.2%
Selling/Promotion Expense	17.2%	26.9%	27.2%	28.3%	32.4%	28.2%	25.7%	23.0%
General/Administration Expense	21.6%	16.4%	22.3%	30.0%	35.3%	43.1%	38.1%	29.5%
Operating Income	22.8%	27.5%	39.7%	35.1%	28.3%	10.7%	-40.4%	-5.4%
Interest/Other Income	47.8%	-51.8%	-48.3%	-53.2%	-85.3%	-55.7%	-56.0%	-43.8%
Net Income Before Taxes	24.0%	22.9%	29.2%	30.2%	22.1%	9.2%	-41.1%	-6.2%
Provision for Income Taxes	22.1%	22.9%	33.2%	40.4%	28.2%	12.9%	-40.0%	-7.5%
Net Income	25.1%	22.9%	26.9%	24.2%	18.5%	6.9%	-41.8%	-5.3%
Basic Weighted Average Shares	-0.5%	-2.0%	-2.0%	-4.6%	-3.9%	-3.2%	-3.2%	-0.3%
Basic EPS	25.8%	25.4%	29.4%	30.2%	23.3%	10.4%	-39.9%	-5.0%
Diluted Weighted Average Shares	-1.0%	-1.8%	-2.2%	-2.7%	-1.7%	-1.1%	-1.0%	-0.3%
Diluted EPS	26.4%	25.1%	29.7%	27.7%	20.5%	8.0%	-41.2%	-5.0%

% of Revenue	1Q08	2Q08	3Q08	4Q08	1Q09e	2Q09e	3Q09e	4Q09e
Total Revenue	100.0 %	100.0 %	100.0 %	100.0 %	100.0 %	100.0 %	100.0 %	100.0 %
Instructional/Educational Expense	32.6%	33.6%	35.1%	31.3%	30.6%	32.9%	37.5%	32.4%
Gross Profit	67.4%	66.4%	64.9%	68.7%	69.4%	67.1%	62.5%	67.6%
Selling/Promotion Expense	15.6%	17.1%	26.4%	18.7%	16.2%	18.1%	29.7%	20.5%
General/Administration Expense	15.2%	15.0%	17.5%	15.5%	16.2%	17.7%	21.6%	18.0%
Operating Income	36.6%	34.3%	21.0%	34.5%	37.0%	31.3%	11.2%	29.1%
Interest/Other Income	2.1%	0.8%	1.0%	0.7%	0.2%	0.3%	0.4%	0.4%
Net Income Before Taxes	38.7%	35.1%	22.0%	35.2%	37.2%	31.6%	11.6%	29.5%
Provision for Income Taxes	14.5%	13.3%	8.5%	14.0%	14.6%	12.4%	4.6%	11.6%
Net Income	24.2%	21.8%	13.5%	21.2%	22.6%	19.2%	7.0%	17.9%

14. Additional Info

(Amounts in $Ms, except ratios)	
Current debt	0.0
Current equity	176.1
Current tangible book value	176.1
Current market value	2,412.0
Current cash	107.3
Current DSO	125.0
Current DIO	na

	FY2008	FY2009e	FY2010e
EBIT	126.9	131.0	117.6
EBITDA	137.6	145.5	136.1
Free cash flow	67.9	54.9	63.3
Surplus cash flow (net income+D&A-capex)	70.9	54.9	63.3
Capex	20.7	40.0	28.0
EV/EBITDA	17.5	16.6	17.7
EV/(EBITDA-capex)	20.6	22.9	22.3