https://www.theatlantic.com/magazine/archive/2016/11/why-for-profit-education-fails/501140/

Why For-Profit Education Fails

Moguls' good intentions too often betray them.

Justin Renteria

Text Size

Like *The Atlantic*? Subscribe to The Atlantic Daily, our free weekday email newsletter.

EARLIER THIS YEAR, LeapFrog Enterprises, the educational-entertainment business, sold itself for $1 a share. The deal came several months after LeapFrog received a warning from the New York Stock Exchange that it would be delisted if the value of its stock did not improve, a disappointing end to the public life of a company that had the best-performing IPO of 2002.

LeapFrog was one of the very last remaining of the dozens of investments made by Michael Milken through his ambitiously named Knowledge Universe. Founded in 1996 by Milken and his brother, Lowell, with the software giant Oracle's CEO, Larry Ellison, as a silent partner, Knowledge Universe aspired to transform education. Its founders intended it to become, in Milken's phrase, "the pre-eminent for-profit education and training company," serving the world's needs "from cradle to grave."

Investors aiming to start an education revolution have, with regularity, lost their shirts.

Knowledge Universe businesses included early-childhood learning centers, for-profit K–12 schools, online M.B.A. programs, IT-training services for working professionals, and more. Milken's penchant for secrecy makes a comprehensive assessment impossible—most of the businesses were privately held and some were sold to private buyers for undisclosed sums. But of the companies about which there is public information, most, like LeapFrog, ended badly. Education remains untransformed.

Milken was far from alone in the belief that education could be revolutionized through radical new business models. In 2012, the media mogul Rupert Murdoch and the former New York City schools chancellor Joel Klein established the Amplify division within News Corp. At the time of his initial investment, Murdoch described K–12 education as “a $500 billion sector in the U.S. alone that is waiting desperately to be transformed.” Their idea was to overturn the way children were taught in public schools by integrating technology into the classroom. Although inspirational, the idea entailed competing with a series of multibillion-dollar global leaders in educational hardware, software, and curriculum development. After several years and more than $1 billion, with no serious prospect of ever turning a profit, Murdoch and Klein sold their venture for scrap value to Laurene Powell Jobs, Steve Jobs’s widow, last year.

Indeed, over the past couple of decades, a veritable who’s who of investors and entrepreneurs has seen an opportunity to apply market discipline or new technology to a sector that often seems to shun both on principle. Yet as attractive and intuitive as these opportunities seemed, those who pursued them have, with surprising regularity, lost their shirts. JP Morgan backed Edison Schools’ ill-conceived effort to outsource public education in the late 1990s and saw the business lose 90 percent of its value during its four years as a public company; Goldman Sachs was one of many private-equity firms that came up empty after betting on the inevitable ascendance of for-profit universities; the billionaire Ronald Perelman shut down his futuristic K–12 educational-technology company, GlobalScholar, after spending $135 million and concluding that the software was faulty and a “mirage”; by the time the hedge-fund titan John Paulson was able to sell the last of his stake in Houghton Mifflin Harcourt, in 2015, he had likely lost hundreds of millions financing the company’s misguided mission to remake textbook publishing.

Not all financial investments in education end badly, but the number that have is notable, as are the magnitudes of the fiascos, in stark contrast to the successes of many of these same investors in other domains. The precise sources of failure in each instance are diverse, as are the educational subsectors targeted and the approaches pursued. But what many share is the sweeping nature of their ambition.

YOU CAN SEE this ambition in both the scale and the scope that many of these ventures sought out—often simultaneously. Scale can be an important driver of sustainable profitability, but it is striking just how many for-profit educational ventures—particularly those centered on bricks-and-mortar educational services—have confused scale, which is a relative concept, with absolute size. For services like day care and classroom education, local or regional density of operations can be advantageous, because it enables efficient management of personnel (by far the largest cost), the sharing of fixed expenses like marketing, and sometimes even pricing power. The benefits of a national footprint are seldom as obvious. Yet it is national scale that many ventures have sought. For example, Milken’s effort to roll up many of the nation’s day-care centers began in 1998 and reached its zenith with the $1 billion purchase of KinderCare in 2005. The inherently local nature of this business, however, ensured that its profitability did not improve as it grew larger. When Milken finally sold the business last year, he received less than what he’d paid for his day-care acquisitions over the previous 17 years.

Scope, meanwhile, can be the enemy of scale, particularly when pursued at the same time. Spreading investments across a variety of segments can impede the achievement of scale in any of them and also scatter the attention of executives. Time and again in education, big-name investors have launched companies with the broadest ambitions, only to be undone by more-focused players. For example, an early Milken investment wisely targeted a growing population of families who wanted to homeschool their children and were increasingly eligible for public funding through distance-learning charter schools. The business, founded in 1999 and called K12, managed the technology, teaching, and curriculum needed to deliver the full educational experience to kids online. The problem was that Milken wanted to do more than provide a technology-enabled service or run a profitable business; he wanted to transform education by also delivering an entirely new, proprietary, all-digital curriculum.

A competing business, Connections Academy, started later but decided to concentrate on perfecting its technology service and simply adapting the best of existing curricula to its digital environment. Even at a fraction of the size of K12, Connections Academy had a higher profit margin, and five years ago, it sold for a price far higher than K12’s current valuation. Today, K12’s stock trades at a price far below that of its 2007 IPO.

There is reason to suspect that ego has played a meaningful role in many of these investments. What else, for instance, could explain the consistent fascination with business models that hinge on relationships with elite universities? Great universities have a number of exceptional qualities, but they are not good organizations with which to partner. They are generally much more interested in protecting their exclusivity than in growing, and their bureaucratic decision making leads them to act slowly and cautiously. These inclinations serve them just fine: Exclusivity and reputation are essentially self-perpetuating for top schools, as reflected in how rarely university rankings change significantly. But that also means the outcome of any commercial arrangements the universities enter into are likely to be lopsided in the schools' favor.

An extreme example of this unhealthy preoccupation with the most-selective institutions is a Milken-backed business originally called Knowledge University, which agreed to finance the expensive development of online-M.B.A. course material and then share revenues, largely in exchange for simply being able to mention its association with institutions like Columbia, Stanford, and the University of Chicago. When Columbia Business School, where I am a co-director of the media-and-technology program, signed its deal with the company—which guaranteed a minimum payment of $20 million over five years—my colleague Bruce Greenwald was quoted as being supportive because the deal "looked like money for nothing." It was, and the company eventually pivoted to another business model (and then collapsed in the face of a federal civil fraud lawsuit). The carcass of the business was sold to K12 for a nominal amount.

YET DESPITE THE FACT that ego and the drive for status are inseparable from many of these ventures, and that they are for-profit enterprises, my own study of these businesses and the people behind them strongly suggests a genuine—and in many cases intense—desire by the founders and investors to improve education. That desire is often associated with deep-seated beliefs about what is wrong with the current system. The evidence suggests that the intensity of desire and belief can cloud the judgment of even the most sophisticated investor. The pursuit of high-minded ideals and the belief that the status quo is so bad that it can't be hard to improve upon causes many investors to devalue execution—yet execution is particularly crucial to the survival of organizations that take on overly broad mandates.

Should anyone care that a bunch of very rich people have failed in these ventures? In fact, this should matter to anyone concerned about education. That failure, repeated so consistently, has given credible fodder to people who resist the active participation of for-profit enterprises in the educational sphere. But that sphere will always comprise public and private, nonprofit and for-profit institutions, and for-profit businesses play an essential role. Public-sector funding is subject to political whims, and the nonprofit sector's funding sources are also typically uncertain. Advocates of for-profit education often understandably emphasize the role that market forces play in improving quality and efficiency. But the most constructive role the for-profit segment may play is in providing a unique level of stability to the educational ecosystem when (and only when) it establishes sustainable business models.

Regardless of whether investors try to do well by doing good, with respect to the operation of for-profit ventures, one basic fact is incontrovertible: One cannot do good for very long if the business does not do well enough to survive. The possibility of doing good would expand exponentially if more investors and managers shifted their attention toward the question of what qualities are most important in building a successful educational franchise.

The greatest educational-business successes have come from a series of targeted, incremental steps forward within tightly defined markets. Recent examples include a business based on plagiarism detection; another that provides tools to high-school students and guidance counselors for college and career selection; and another that delivers day care and early-learning programs sponsored by employers. It is no coincidence that Laurene Powell Jobs insisted that News Corp radically contract the scope of Amplify's operations before she agreed to buy the company. Since the purchase, she has continued to spin off marginally related businesses and has greatly narrowed the subject-matter and grade-level focus—targeting middle-school reading, for instance. It is precisely the exit of Amplify's two original visionaries—Murdoch and Klein—that has created the possibility of a successful and socially beneficial future for the company.

As frustrating as they may be to education investors, modest, incremental successes can serve as both a platform and a stimulus for broader transformations to come. Without a sustainable business model, however, even the most inspired investors and entrepreneurs will ultimately only build a legacy of disillusionment.

This article is adapted from *Class Clowns: How the Smartest Investors Lost Billions in Education*, published in November.

Christle Whittle: Bad Management