INVESTMENT THESIS

SHORT: ITT Educational Services, Inc. (ESI: $108.67)

Company	ITT Educational Services, Inc.	**FY1 PE (Consensus)**	16.5	**YTD % Change**	7.3%
Ticker	ESI	**FY2 PE (Consensus)**	14.2	**52 Week High**	133.75
Stock Price	$108.43	**FY1 EV/EBITDA**	8.8x	**52 Week Low**	52.33
Mkt Cap	4,155	**FY2 EV/EBITDA**	7.7x	**200-Day**	94.59
Enterprise Value	3,940	**FCF Yield (Trailing)**	3.2%	**50-Day**	114.13
Net Debt	-215	**ROE**	152.0%	**RSI**	49.00
Credit Ratings	N/A	**ROIC**	45.0%	**Avg. Daily Vol. (000s)**	1889.0
Cash/Share	$9.33	**Dividend Yield**	N/A		

Investment Thesis Overview:

We have followed the for-profit education sector for almost a decade now. Companies such as Apollo Group, DeVry, Inc. and ITT Educational Services, Inc., among others, have generated fantastic enrollment, revenue and EPS as they gained significant market share from the traditional academic sector. Over the past 12-18 months, most stocks in the space have outperformed the market by a substantial amount due in large part to a significant uptick in demand for higher education caused by rising unemployment. Lead costs have plummeted, conversion rates have improved and demand remains robust, in many respects it is the best time to be a for-profit provider of postsecondary education. However, we think have recently witnessed the early signs of what could be a meaningful inflection point for the revenue and earnings growth prospects for the group.

Over the past 2-3 years, we have grown increasingly concerned that some companies in the space were beginning to price themselves out of the market; that is tuition levels were approaching, if not exceeding the level at which a graduate could consistently service their student debt burden. In many respects, this is an indictment of the higher education system in the US at large. Simply stated, tuition has become too expensive. If existing shareholders in the space have not started to focus on the importance of student debt burdens, then investor reaction to APOL's recent earnings report and ESI's 10-K disclosure about its preliminary 2007 cohort default rates should have served as an alarm bell. Some companies in the sector will weather the pending cohort default rate storm better than others. **It is our view that ITT Educational Services, Inc. (ESI) could fair the worst – their programs are some of the most expensive and it is no longer clear that graduates earn a strong return on their educational investment.** We anticipate, shares could witness substantial downside in the near-term as the prospect of higher cohort default rates at its schools becomes an "anvil" hanging over the head of shareholder sentiment. Our thesis is based on the following:

1. Over the next few quarters, ESI will continue to benefit from strong demand for its programs caused by the economic downturn. This is already reflected in consensus – strength should be sold or shorted.
2. ESI has broken "the more you learn, the more you earn" student covenant.

3. Student debt burden to attend ITT Tech now rivals mortgage debt burden at the peak of the housing bubble – cohort default rates should continue to surge higher.
4. Our proprietary survey suggests that students are finding it increasingly difficult to make student loan payments.
5. ESI has not disclosed that it is subject to a qui tam lawsuit based on alleged violations of the incentive compensation provisions of the Higher Education Act.
6. **ESI is over-earning at the expense of its students - tuition price cuts will become a necessary remedy for the company to fix its business model, in our view. We estimate that restoring the affordability of ESI's programs could negatively impact EPS by $2.50-$3.00 in 2010, if not more.**

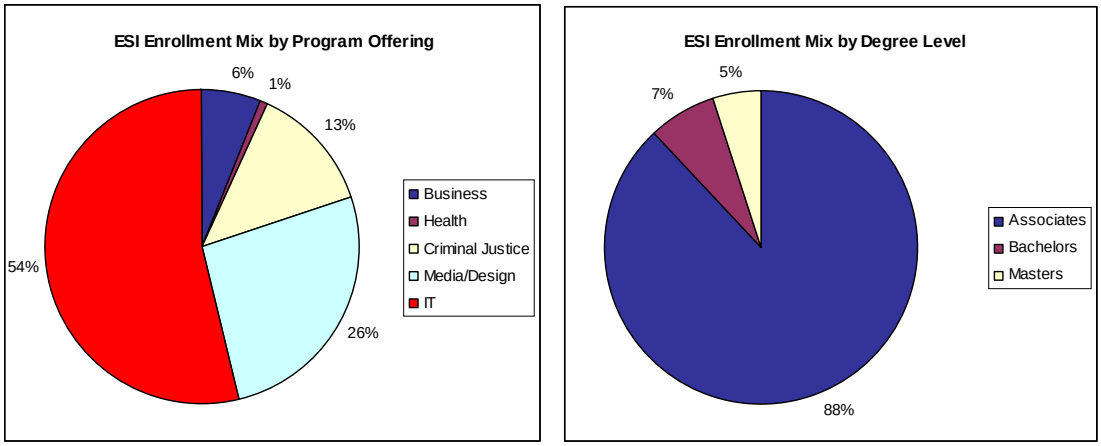
RISKS:

The risks to our investment thesis are the following:

1. Preliminary data for 2008 cohort default rates will not be released until Jan/Feb 2010; it is possible that shares could rally on the back of what we expect to be strong earnings results over the next few quarters.
2. The announcement of new private lending partnerships could allay investor concerns regarding ESI's balance sheet.
3. Further expansion of government backed student lending programs would represent a significant positive for ESI shares.

BRIEF COMPANY DESCRIPTION AND TRADING BACKGROUND

ITT Educational Services, Inc. (ESI) is a leading for-profit provider of postsecondary education. The company operates 105 schools and nine learning sites located in 37 states. ESI offers associate, bachelor and master degree programs in information technology, electronics technology, drafting and design, business, criminal justice and health sciences. More than 80% of the company's students are enrolled in associate's degree programs. As of December 31, 2008, ESI had more than 62,000 students enrolled at its ITT Technical Institute locations across the country.



Source: Company reports, PAA Research estimates

Trading Background:

ESI's stock has had a strong run over the past 12-months. Shares traded at multi-year lows in 1H08 due to investor fears about the company's ability to secure tuition funding from private lenders, which comprised more than 20% of revenues in 2008. The stock traded at less than 10x earnings during that period. Since that time, the company has reported strong results and successfully managed the transition towards financing some student tuition costs using its own balance sheet. The stock sold off sharply in February following the release of the company's 10-K which included a disclosure that cohort default rates for its schools in 2007 had increased 3-5% on average over 2006 levels. Over the past 2-3 years, the stock has struggled with the 125-130 level.

Short Dynamics and Insider Trading

The short interest in ESI stands at 5.7 million shares, which represents 16% of the float and 3.6 days to cover. The short interest has declined slightly since February following the sharp sell-off in shares.

For the most part, insiders have been sellers of shares in the past 12-months, although not at elevated levels.

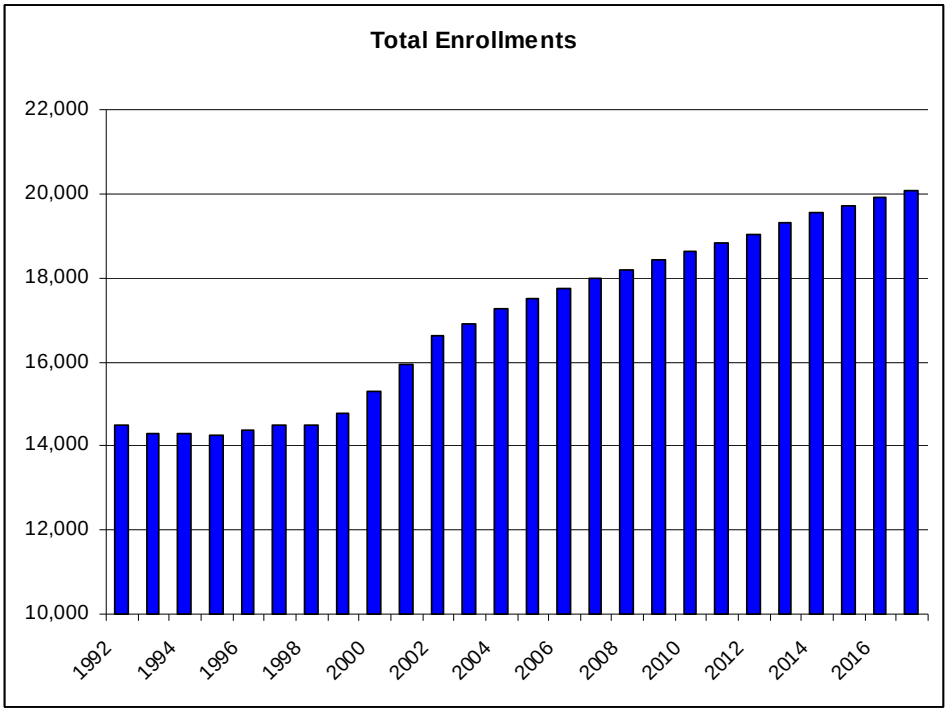
A BRIEF PRIMARY ON THE HIGHER EDUCATION SPACE AND WHY ENROLLMENT GROWTH IS LIKELY TO REMAIN STRONG

Higher Education in the United States will still be a Growth Industry, but the Secular Tailwind from the "Echo-Baby Boom" has now Peaked

Over the past 60 years, total enrollments in degree granting higher education institutions have increased at a compound annual growth rate of 3.5% driven primarily by the following factors: 1) Population growth, 2) increased matriculation rates (45% in 1960 vs. 66% in 2006), 3) expansion of government student loan programs, 4) Increased capacity at higher education institutions, and 5) Innovative delivery methods (i.e. online). According the Department of Education there are now more than 18MM students enrolled in degree programs in the US.

Over the past 15-years, total enrollments have increased at a slower rate – 1.4%, in part due to the "law of large numbers", slower gains in matriculation rates, and lower population growth. According to the department of education, 2008 will be a record year for the number of high school graduates. The "echo baby boom" has driven

increased demand for higher education over the past 10-15 years. Going forward, the department of education expects total enrollment to increase at 1.0% CAGR for the next decade. The Department of Education's projections are based primarily on demographic trends and to a lesser extent the overall economic environment.

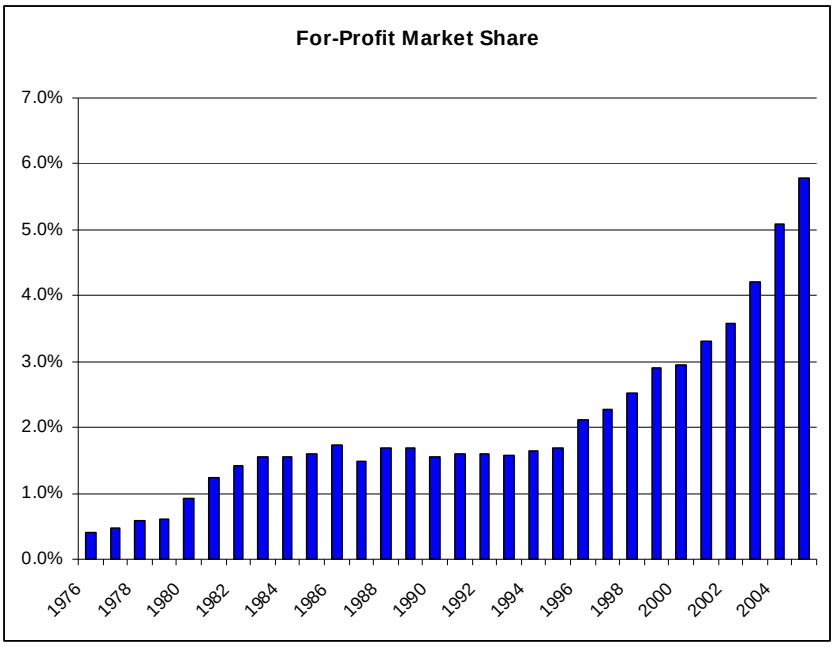


Note: Figures are in 1,000's.
Source: Department of Education

Despite Slowing Secular Growth, the For-Profit Providers of Postsecondary Education Should Continue to Experience Strong Enrollment Growth through Market Share Gains

Over the past thirty years, the for-profit providers of postsecondary education have increased their market share from 0.4% to almost 6% (through 2005, the last year for which data was available. These market share gains can be attributed to; 1) the ability to increase capacity to meet demand, 2) more relevant course offerings and degree programs, and 3) more convenient campus locations and delivery models for working adults. Given the distressed state of state budgets and college endowments it is highly unlikely that the traditional university system will be able to respond to any incremental demand over the next 2-3 years. For profit providers of postsecondary on the other hand continue to expand campus locations, introduce new programs and

enhance online offerings.



Source: Department of Education

Rising Unemployment Leads to Increased Demand for Higher Education and Larger Tuition Price Increases

Periods of economic weakness have lead to increased demand for higher education within the long-term secular growth trend. "The more you learn, the more you earn" has been the creed of unemployed adults who look to improve their employment prospects through educational attainment. Over the past 60 years, enrollments in higher education have increased 4.9% in years in which the number of unemployed has increased compared to 3.5% for all periods. The correlation of total enrollments and the number of unemployed over the past 60 years is 0.47. Over past 30 years growth in higher education has slowed, but the correlation with unemployment trends has increased slightly to 0.55.

In addition, tuition prices typically increase at a more rapid rate during periods of economic weakness as public universities attempt to stem the gap of lower state budgets and private institutions compensate for reduced endowments. Over the past 60 years tuition costs have increased 6.0% and 6.7% at public and private higher education institutions, respectively. During periods of economic weakness tuition prices have increased at a rate 1% higher than average. The tables below compare enrollment and tuition changes during periods of rising unemployment over the past 30 and 60 years.

Past 60 Years	Periods of Rising Unemployment	All Periods On Average	Difference
Total enrollment	4.9%	3.5%	1.4%
Public enrollment	5.9%	4.2%	1.7%
Private enrollment	2.9%	2.3%	0.6%
For-profit enrollment (1)	16.9%	11.0%	5.9%
Public Tuition (2)	7.0%	6.0%	1.0%
Private Tuition (2)	7.7%	6.7%	1.0%

1) For-profit enrollment data back to 1975, 2) Tuition data only goes back to 1964
Source: Department of Education, Bureau of Labor Statistics

Past 30 Years	Periods of Rising Unemployment	All Periods On Average	Difference
Total enrollment	3.1%	1.8%	1.3%
Public enrollment	3.1%	1.6%	1.5%
Private enrollment	3.0%	2.3%	0.7%
For-profit enrollment	15.3%	12.1%	3.2%
Public Tuition	7.8%	6.3%	1.5%
Private Tuition	8.0%	6.9%	1.1%

Source: Department of Education, Bureau of Labor Statistics

Each Recession is Different – Demographic Trends Still Can Impact Enrollment Growth, but Tuition Price Increases Have Accelerated in Most Cases

A number of factors can impact enrollment and tuition prices during a period of rising unemployment, in what would otherwise be a time of accelerated growth in higher education expenditures. The three most important are: demographic trends, overall inflation and credit availability. In the recession of the early 1980's the overall high level of inflation created an umbrella for higher education institutions to increase tuition at double digit rates. Tuition price growth accelerated 4%, while enrollment growth picked up slightly. The table below (and subsequent tables) compares enrollment growth and tuition price increases for public universities to that of private colleges and institutions. The Department of Education does not break out for-profit tuition statistics individually.

	1980-1982 Avg.	1977-1979 Avg.	Difference
Public Tuition	10.8%	6.6%	4.2%
Private Tuition	12.1%	7.9%	4.2%
Total Enrollment	2.4%	1.7%	0.8%
Public Enrollment	2.4%	1.5%	0.9%
Private Enrollment	2.5%	2.4%	0.1%
For-Profit Enrollment	36.4%	17.4%	19.0%

Source: Department of Education, Bureau of Labor Statistics

In the recessionary period of the early 1990's, a declining number of high school graduates lead to slower enrollment growth and lower tuition price growth.

	1990-1992 Avg.	1987-1989 Avg.	Difference
Public Tuition	6.1%	5.8%	0.3%
Private Tuition	6.8%	7.5%	-0.7%
Total Enrollment	2.3%	2.7%	-0.4%
Public Enrollment	2.5%	2.9%	-0.4%
Private Enrollment	1.6%	2.0%	-0.4%
For-Profit Enrollment	0.3%	2.5%	-2.2%

Source: Department of Education, Bureau of Labor Statistics

In the recession of 2001, both tuition price and enrollments increased at a more rapid rate. The turn of the century will be noted for the proliferation of for-profit postsecondary education institutions and the explosion of degree offerings for working adults.

	2001-2003 Avg.	1998-2000 Avg.	Difference
Public Tuition	6.8%	3.6%	3.2%
Private Tuition	4.8%	4.9%	-0.1%
Total Enrollment	3.4%	1.8%	1.5%
Public Enrollment	3.1%	1.6%	1.4%
Private Enrollment	4.4%	2.5%	1.9%
For-Profit Enrollment	16.5%	11.2%	5.3%

Source: Department of Education, Bureau of Labor Statistics

This Recession Should Lead to Unemployment Levels not seen since the Early 1980's – Enrollment Demand Should Exceed Capacity, Tuition Price Increases Will be Governed by Credit Availability

The increase in the number of unemployed in the current economic downturn has already eclipsed that of the prior recession. It appears increasingly likely that the unemployment rate could exceed that of the prior recession. Based on our regression analysis, this could result in a surge of demand for higher education well beyond what could be currently absorbed by the existing university system. In its base case forecast, the Department of Education projects that enrollments in higher education will increase by 216,000 in 2009. We have conducted a regression analysis using the change in the number of unemployed and total enrollment over the past 30-years as the two primary inputs. The analysis suggests that there could be as many as 1.3 million incremental adults (compared to base case) that would pursue a higher education degree program if the unemployment rate eclipses 9.0% in 2009.

Increase in Number of Unemployed	Corresponding Unemployment Rate	Increase in Total Enrollments	Difference vs. Forecast
250	6.9%	301	85
500	7.1%	398	182
750	7.3%	495	279
1,000	7.4%	592	376
1,250	7.6%	689	473
1,500	7.7%	786	570
1,750	7.9%	883	667
2,000	8.1%	980	764
2,250	8.2%	1,077	861
2,500	8.4%	1,174	958
2,750	8.5%	1,271	1,055
3,000	8.7%	1,368	1,152
3,250	8.9%	1,465	1,249
3,500	9.0%	1,562	1,346
3,750	9.2%	1,659	1,443
4,000	9.4%	1,756	1,540

Note: Assumes a constant labor force, all numbers in 1,000's except percentages
Source: PAA Research

A BRIEF DISCUSSION OF COHORT STUDENT DEFAUT RATES – WHAT THEY SHOW AND WHAT THEY DO NOT

Under the Higher Education Act a postsecondary institution can lose eligibility to participate in certain Title IV programs, if the rate at which the students default on their federal student loans exceed certain percentages. The rates are calculated per institution and based on the number of students that default (not the dollar amount). An institution whose cohort default rate exceeds 25% for three consecutive years loses eligibility to participate in the vast majority of Title IV programs. Starting with the 2009 cohort, the maximum default rate to determine institutional eligibility to receive Title IV funds will be increased to 30%. However, as a trade off, the amount of time used to measure defaults will be extended from one year to two years. This will likely result in a higher cohort default rate for all industry participants.

It is critically important to understand the methodology used to calculate the cohort default rate, which in general understates credit risk for a particular group of student loans. The data is calculated based on a fiscal year that begins October 1st and ends September 30th. The cohort is based on the number of students that enter the repayment period in a particular fiscal year. The repayment period typically begins 6-months after a student graduates or withdraws from a postsecondary institution. Student loan defaults are then calculated through the following fiscal year to determine the numerator in the cohort default rate calculation.

For example, if a student began repayment in October 2006 and defaulted on their student loan in August 2008, they would be captured in the cohort default data for 2007. However, if that student were to default two months later, in October 2008 they would not be captured in the cohort default rate. **In short, any student that defaults 24-months after the initial repayment period WILL NOT be captured in the cohort default data.** In addition, a lender can not make a claim for a defaulted loan with a guaranty agency until it is more than 270 days delinquent. A loan is not considered in default until a claim has been PAID by a guaranty agency. For example, a student that graduates in October 2006, enters repayment in March 2007, makes payments on his student for 12-months and then never makes another loan payment will actually never be captured in the cohort default rate data (as of the end of the measurement period, 9/30/08 his loan was only 180 days delinquent). The cohort default rate is not a good indicator of overall student loan outcomes, in fact during a period of rising unemployment it will likely massively understate the level of defaults associated with a particular cohort. As mentioned earlier the cohort default rate measurement will be changed to measure a period of 12-36 months after the initial repayment period. This will be a better measurement of student loan quality, but still not a great one.

INVESTMENT THESIS IN DETAIL

"The more you learn, the more you earn" Student Covenant

The US higher education system, in many respects is the envy of the world due to the quality of our educational institutions and the access to education we (as tax payers) provide to all potential students, irrespective of economic background. It is a universally accepted truth in the United States that "the more you learn the more you earn". This simple concept is touted by politicians, accepted as fact by students, and used as a marketing tool by the vast majority of for-profit postsecondary educational institutions in this country. Tax payers continue to vote for politicians that support higher funding for education in part due to their steadfast belief in the universal truth of "the more you learn, the more you earn".

The table below outlines the median earnings for adults in the US by level of education obtained. The data does confirm that those who learn more, earn more. For example, the median income for someone with a bachelor's degree was approximately $19,000 higher in 2007 than that of someone that only graduated from high school. Not only do individuals earn more on average if they obtain a degree in higher education, but the earnings gap has expanded. In 1994, an individual with a bachelor's degree earned approximately $12,500 more on average than someone that only graduated from high school. This compares to $19,000 in 2007.

Median Earnings

	H.S. Grad	YOY Growth	Associates Degree	YOY Growth	Bachelors Degree	YOY Growth	Masters Degree	YOY Growth
1996	$20,537	5.1%	$26,584	4.5%	$32,142	1.8%	$41,147	0.7%
1997	$21,252	3.5%	$26,820	0.9%	$34,625	7.7%	$42,651	3.7%
1998	$22,077	3.9%	$29,664	10.6%	$36,591	5.7%	$44,159	3.5%
1999	$22,448	1.7%	$29,777	0.4%	$37,989	3.8%	$47,337	7.2%
2000	$24,267	8.1%	$30,774	3.3%	$40,314	6.1%	$48,972	3.5%
2001	$24,656	1.6%	$31,536	2.5%	$40,939	1.6%	$50,399	2.9%
2002	$25,081	1.7%	$31,358	-0.6%	$41,361	1.0%	$50,704	0.6%
2003	$25,935	3.4%	$31,910	1.8%	$41,800	1.1%	$51,244	1.1%
2004	$26,104	0.7%	$32,383	1.5%	$42,087	0.7%	$51,733	1.0%
2005	$26,505	1.5%	$35,009	8.1%	$43,143	2.5%	$52,390	1.3%
2006	$27,384	3.3%	$35,274	0.8%	$46,435	7.6%	$55,445	5.8%
2007	$28,290	3.3%	$36,352	3.1%	$47,240	1.7%	$56,707	2.3%

Source: US Census

While this data is certainly compelling for those interested in pursuing a higher education degree, we prefer to look at the data in a slightly different way. Our objective is to determine how much better off a student would be from an earnings perspective, after-tax, if he or she was to pursue a higher degree. There are two tables below: the first compares the median incremental after-tax income of obtaining an associates, bachelor's or master's degree, the second, the monthly student loan payment required upon graduation for students attending both public and private, two and four year colleges and universities. For the purposes of this analysis, we have assumed that students have financed 100% of their education at the fixed Stafford loan rate in the year in which they graduated (we recognize that the cost of tuition at most private schools exceeds federal loan limits, but adding on the cost of higher priced private student loans would only further confirm our findings).

Median Monthly After Tax Income Difference

	Associates - High School	Bachelors - HS	Master - Bachelors
1994	$377	$836	$158
1995	$393	$801	$279
1996	$403	$506	$525
1997	$371	$603	$468
1998	$506	$663	$441
1999	$489	$719	$545
2000	$434	$734	$505
2001	$459	$744	$552
2002	$418	$741	$545
2003	$398	$709	$551
2004	$419	$715	$563
2005	$421	$750	$539
2006	$379	$883	$526
2007	$386	$870	$552

Monthly Student Payment Costs

	Public 2-yr.	Private 2-yr.	Public 4-yr	Private 4-yr.
1992	$26	$133	$108	$484
1993	$27	$136	$111	$489
1994	$29	$142	$121	$524
1995	$32	$150	$133	$577
1996	$34	$159	$142	$618
1997	$37	$168	$149	$657
1998	$38	$169	$153	$687
1999	$37	$163	$155	$708
2000	$39	$173	$164	$752
2001	$38	$194	$169	$779
2002	$35	$203	$167	$752
2003	$36	$214	$175	$740
2004	$39	$233	$192	$767
2005	$44	$253	$219	$845
2006	$50	$279	$252	$965
2007	$52	$145	$276	$1,060

Source: College Board, proprietary analysis

Comparing the data sets one can see that students attending a private 4-year college or university are no longer getting a positive return on their educational investment. For the past decade, the cost of paying off student loans on a fully

financed tuition for a 4-year bachelor's degree program at a private school has exceeded the incremental earnings benefit of obtaining that degree. There are many factors that have contributed to the continued popularity of private 4-year postsecondary institutions the most important of which is that demand for higher education is incredibly inelastic. However, just as surging mortgage default rates have caused public policy makers to question the merits of universal homeownership; we anticipate swelling student loan defaults in the next few years will cause consumers and politicians alike to question why the cost of higher education in many cases now exceeds its economic benefits. The tables below compare the net incremental income (After tax income minus the cost of servicing his/her student loan) of attending specific types of colleges. **Once again it is clear that the cost of a bachelor's degree program at a 4-year private college or university does not offer a reasonable economic return to the student.**

Median Income
Net Incremental Income (After-tax income - Debt Payment)

	Public 2-yr.	Private 2-yr.	Public 4-yr	Private 4-yr.
1996	$369	$244	$364	-$113
1997	$334	$203	$454	-$54
1998	$468	$337	$509	-$24
1999	$451	$326	$565	$12
2000	$395	$261	$570	-$18
2001	$421	$264	$575	-$35
2002	$384	$216	$574	-$12
2003	$363	$184	$535	-$30
2004	$379	$186	$523	-$52
2005	$377	$168	$531	-$96
2006	$329	$100	$631	-$82
2007	$334	$241	$594	-$190

Student Loan Payment as % of Incremental Income

	Public 2-yr.	Private 2-yr.	Public 4-yr	Private 4-yr.
1996	8.5%	39.4%	28.1%	117.7%
1997	10.0%	45.2%	24.8%	140.3%
1998	7.4%	33.4%	23.1%	155.6%
1999	7.7%	33.3%	21.5%	129.8%
2000	9.0%	39.8%	22.3%	149.0%
2001	8.3%	42.4%	22.8%	141.1%
2002	8.3%	48.4%	22.5%	138.1%
2003	9.0%	53.7%	24.6%	134.3%
2004	9.4%	55.6%	26.9%	136.3%
2005	10.4%	60.1%	29.2%	156.7%
2006	13.1%	73.6%	28.5%	183.5%
2007	13.6%	37.6%	31.7%	191.9%

Source: College Board, proprietary analysis

Return on Educational Investment for a Student Attending ITT Tech is Now Negative – ESI Has Broken the "More You Learn, The More You Earn" Student Covenant

In many respects, ESI's problems are really an indictment of the overall higher education sector. However, it is our view that ESI is the most egregious violator of "the more you learn, the more you earn" covenant. That is to say, the company's program offerings are some of the most expensive in the for-profit postsecondary education space and graduates appear to receive little return for their educational investment. Over the past 12-years, the company's tuition has increased at a compound annual rate of 7%, while the average starting salary for graduates of the ITT Technical Institute has increased at 4%. This trend is not sustainable. **Additionally, the average starting salary for an ITT Tech grad is barely higher than the median salary for a high school graduate.**

We also looked at the return on educational investment for a student graduating from ITT Tech based on the average starting salary and the cost of repaying full tuition. Once again, we have assumed that the student has financed 100% of tuition

at the fixed Stafford loan rate for the year in which they graduated. The middle column labeled "Incremental Income" compares the incremental after-tax monthly income earned by an ITT Tech grad compared to a high school graduate. The final column is the most telling. The monthly payment on a 10-year loan for tuition now exceeds the incremental earnings benefit of obtaining an associate's degree at ITT Tech. This dynamic was only exacerbated in 2008 when the average starting salary for an ITT Tech graduate only increased 3%, compared to a 5% increase in tuition. **This analysis would suggest that a student might be better off not going to ITT Tech at all.**

	ESI Starting Grad Salary	Vs. Median HS Graduate	Vs. Median Assoc. Grad	Monthly Income	Incremental Income	Total Degree Cost	Debt Svc. Cost	% of Montly Income	Median Debt Svc. Cost vs. Assoc vs. HS After-tax Inc.
1996	$20,130	98.0%	75.7%	$1,342	-$27	$19,792	$243	18.1%	60.2%
1997	$21,228	99.9%	79.1%	$1,415	-$2	$20,801	$255	18.0%	68.7%
1998	$23,227	105.2%	78.3%	$1,548	$77	$21,841	$268	17.3%	53.0%
1999	$24,600	109.6%	82.6%	$1,640	$143	$23,760	$282	17.2%	57.6%
2000	$25,450	104.9%	82.7%	$1,697	$79	$27,744	$321	18.9%	74.0%
2001	$28,100	114.0%	89.1%	$1,873	$230	$29,136	$356	19.0%	77.7%
2002	$27,600	110.0%	88.0%	$1,840	$168	$32,768	$364	19.8%	86.9%
2003	$27,300	105.3%	85.6%	$1,820	$91	$34,656	$352	19.3%	88.3%
2004	$26,940	103.2%	83.2%	$1,796	$56	$35,328	$348	19.4%	83.1%
2005	$27,453	103.6%	78.4%	$1,830	$63	$37,056	$364	19.9%	86.5%
2006	$28,700	104.8%	81.4%	$1,913	$88	$38,880	$418	21.9%	**110.3%**
2007	$31,000	109.6%	85.3%	$2,067	$181	$42,144	$485	23.5%	**125.6%**

Source: Company reports, US Census, PAA Research

Student Debt Burden Increasingly Resembles the Mortgage Debt Burden at the Peak of the Housing Bubble

Based on our analysis the average student graduating with an associate's degree from ITT Tech would have to allocate close to 20% of gross income towards servicing student loans (more than 20% of after-tax income). Historically, this has proven to be a "tipping point" for other forms of consumer credit, most notably mortgage debt. In the table below we compare the national average for mortgage payments as a percentage of median gross income in the prior two housing recessions to that of the average student loan payment for a student graduating with an associate's degree from ITT Tech (once again we've assumed 100% of tuition is financed at the fixed rate for Stafford loans). This data suggests a very high level of student loan default for graduates of ITT Tech in the coming years.

Mortgage Payments as % of Gross Median Income		Mortgage Payments as % of Gross Median Income		ITT Tech Associate Grad Student Loan Payments as % of Avg. Starting Salary	
1975	20.1%	1995	19.2%	1996	14.5%
1976	19.8%	1996	19.2%	1997	14.4%
1977	20.7%	1997	18.6%	1998	13.8%
1978	22.5%	1998	17.7%	1999	13.7%
1979	25.6%	1999	17.9%	2000	15.1%
1980	31.0%	2000	19.1%	2001	15.2%
1981	35.6%	2001	18.3%	2002	15.8%
1982	35.8%	2002	18.7%	2003	15.5%
1983	29.6%	2003	19.1%	2004	15.5%
1984	28.0%	2004	20.2%	2005	15.9%
1985	26.1%	2005	21.8%	2006	17.5%
1986	23.3%	2006	23.6%	2007	18.8%
1987	21.9%	2007	22.4%	2008	18.2%

Source: National Association of Realtors, Company Reports, PAA Research

Declining Job Placement Rate Does Not Bode Well For Future Cohort Default Rates

One of the strongest marketing hooks for a student considering ITT Tech has been its history of job placement for graduates. Over the last 15 years, ESI's job placement rate has averaged 81%. During the last recession the company's job placement rate dropped below 75%. One would expect to have seen a significant negative correlation between cohort default rates and job placement rates, as well as a positive correlation between the default rate and unemployment rate. In the past recession, this was not the case, which we attribute to a sharp decline in the interest rate charged on student loans from 2002-2004, which dramatically improved the debt service burden for student loans.

Graduation Year	Placement Rate	Starting Salary	YOY Change
1/1/92	77.0%		
12/31/92	80.0%		
12/31/93	82.0%		
12/31/94	85.0%		
12/31/95	87.0%	$20,130	
12/31/96	88.0%	$21,228	5.5%
12/31/97	90.0%	$23,227	9.4%
12/31/98	89.0%	$24,600	5.9%
12/31/99	90.0%	$25,450	3.5%
12/31/00	90.0%	$28,100	10.4%
12/31/01	77.0%	$27,600	-1.8%
12/31/02	73.0%	$27,300	-1.1%
12/31/03	69.0%	$26,940	-1.3%
12/31/04	71.0%	$27,453	1.9%
12/31/05	76.0%	$28,700	4.5%
12/31/06	81.0%	$31,000	8.0%
12/31/07	82.0%	$32,400	4.5%
12/31/08	75.0%	$33,370	3.0%

ITT Technical Institute
Cohort Default Rate

	Low	High
2000	4.5%	17.5%
2001	4.9%	12.7%
2002	2.1%	12.1%
2003	4.4%	14.9%
2004	5.8%	12.7%
2005	5.9%	12.6%
2006	5.5%	12.5%
2007	9.7%	15.3%

Source: Company reports

Looking back at recession in the early 1990's there was a much stronger correlation between the unemployment rate and cohort default rates for ESI. In 1993 and 1994, ESI had three campuses (out of 31) whose cohort default rate exceeded 25% for at least two years and many other of its institutions had default rates in the mid-to-high teens. Interestingly enough, default rates were unusually high even though the company had a job placement rate of 77% in 1992. We think it is possible that the company's job placement rate could drop below 70% in 2009.

	ITT Technical Insittute Default Rate	
Campus	**1993**	**1994**
Houston (West)	27.4%	25.8%
Garland, TX	27.4%	39.1%
San Antonio, TX	25.0%	25.6%
Other 28	23.4%-11.8%	19.9%-11.0%

Source: Company reports

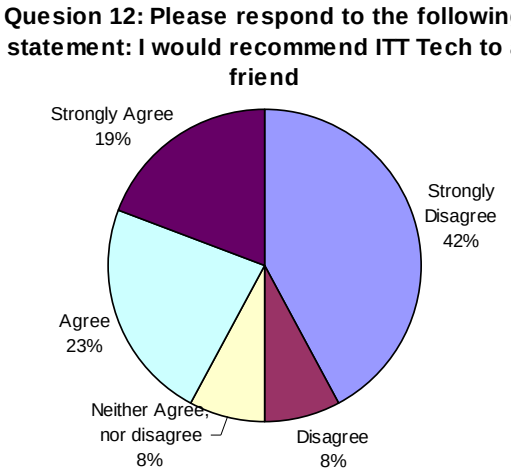
There are already some signs of how difficult it could become for ESI to sustain a high job placement rate for its graduates. According to the 2008 annual report for the Accrediting Council for Independent Schools (ACICS), there were five states in which the job placement rate for ACICS accredited schools dropped below 60%. In each of those states, ITT Tech constitutes a significant portion of the schools accredited by ACICS: Alabama (3 of 9), Idaho (1 of 3), Kansas (1 of 5), North Carolina (3 of 12), and

Wisconsin (3 of 4). It would appear the increase in cohort default rates in 2007 is likely just the tip of the iceberg of what is to come. Remember that the cohort default rate calculation does not include any data from after October 1, 2008. Unfortunately for ESI the worst is yet to come.

Proprietary Survey Suggests ITT Tech is More Popular With Investors then Its Graduates

We conducted a survey of current and former ITT Tech students, in order to better understand how ESI has been able to maintain strong enrollment growth despite offering an increasingly low, if not negative return on educational investment to its students. Approximately 31% of respondents were current students while the rest have graduated in the past 5-10 years. The students currently attend or graduated from ITT Tech locations all over the country and enrolled primarily in associate's degree programs (84% of respondents).

Overall, the survey results do not suggest that ITT Tech has delivered outstanding educational outcomes for all of its graduates. When asked to rate their overall educational experience at ITT Tech on a scale of 1 to 10 (10 being the best), students gave the school an average grade of 5.5. On job placement and career counseling services, current and former students gave ITT tech an average grade of 4.3 (on a scale of 1 to 10). Perhaps the most telling question asked was whether or not the student would recommend ITT Tech to a friend, 50% stated they would not – ouch!

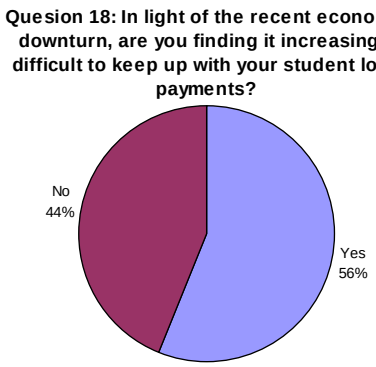


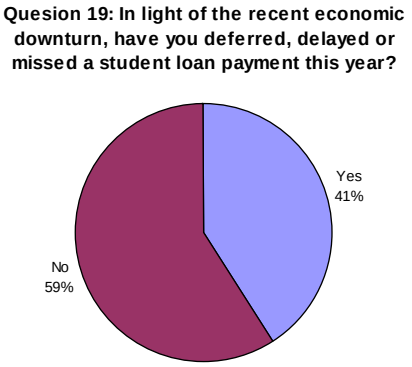
Source: PAA Research

Graduates Are Facing Difficulties Repaying Debt

Perhaps the most interesting findings from our survey relate to the state of the balance sheet for the ITT Tech student or graduate. Not surprisingly, given current economic conditions, many students are having difficulties keeping up with student

loan payments. Approximately 56% of respondents to our survey are having difficulty keeping up with loan payments. Additionally, approximately 41% of respondents indicated that they have deferred or missed a loan payment this year. It is important to remember, a student who graduated in 2004 and defaults on their student loan in 2008 will never show up in the company's cohort default rate.





Source: PAA Research

ESI is Subject to a Qui Tam Lawsuit, which the Company Has Not Disclosed

For the third consecutive quarter, ESI failed to disclose it was subject to a qui tam suit filed against the company. A qui tam, is a suit brought by a private citizen (the relator) on behalf of the federal government under the False Claims Act.

By our count, this would represent the fourth qui tam action filed against ESI in the past decade. We would encourage anyone interested in learning more about prior legal issues ESI has faced to read the company's 10-Ks filed for the years 2001, 2002 and 2004.

This particular lawsuit has been filed by a former recruiter and financial aid officer from one of the company's campuses in Michigan. She worked at ESI for 10-years. The qui tam was originally filed on 7/30/07 and an amended complaint was filed on 6/3/08. Under the Higher Education Act, it is illegal to compensate recruiters/enrollment counselors based on the number of students they enroll. The qui tam claims the company violated the "incentive compensation" provisions of the Higher Education Act.

Several other for-profit providers of higher education have had suits brought against them based on alleged violations of the incentive compensation provisions of the Higher Education Act. APOL has provided an informative timeline of the legal issues it has faced over the past 5-7 years here , which includes some background on the suit it faced based on alleged incentive compensation violations. Additionally, DV was

named in a suit, in the past 12-18 months. Details on the suit can be found in the company's 1Q09 10-Q.

Qui tam actions are reasonably common in the for-profit postsecondary education space. In our 8-9 years following the sector, at least 1-2 have been filed a year against one of the publicly traded players in the space. We are not lawyers and we don't intend to offer any views on the veracity or merits of the suit. **There are allegations made in the suit that would concern any ESI shareholder. We will however ask the question: why hasn't the company disclosed the suit in its SEC filings as all other companies in the space do?**

S&A Expenses Appear Conspicuously Low Relative to the Investment in New School Openings and Enrollment Counselors

S&A expenses for 4Q08 and 2008 were conspicuously low. S&A expense excluding bad debt only increased 5.5% YOY (vs. a 16.9% increase in total enrollments), the lowest rate of growth for the company since 2000 when total enrollments increased 3.5% YOY. On a nominal basis for the full year 2009, S&A expense increased $13.5MM YOY, the lowest rate of increase since 2001. On its 4Q08 conference call, management indicated that advertising spend for the quarter had increased 5% YOY (as the company benefited from lower media costs) and that the number of recruiters employed by ESI had increased 15% YOY.

Let's see if we can back into what we think the S&A increase for ESI should have been in a year in which revenues the company opened 8 campuses, increased advertising spend 5%, and increases recruiter headcount by 15%. According to ESI's 2007 10-K filing, the company employed 1,100 recruiters. In its 2008 10-K filing ESI indicated the company employed 1,400 full and part-time recruiters. Assuming the company hired 300 recruiters/enrollment counselors during the year at somewhere between $50,000-$60,000 in annual salary, that would imply an S&A expense increase of $15-$18MM. This increase of course does not include higher compensation levels for existing recruiters. It is illegal under the Higher Education Act to compensate recruiters explicitly based on the number of students they enroll (note the qui tam); however it is allowable to increase pay based on the overall success of the school or organization. It seems reasonable to think that compensation to recruiters increased as much as 5-10% for the full year in 2008. Finally, ESI opened 8 new campuses in 2008, all of which have some level of S&A expense associated with them. By our math, the increase in compensation to existing recruiters and the salaries paid to new recruiters would probably cost ESI $20-$25MM annually (at a minimum), or more than the entire amount S&A excluded bad-debt increased nominally for 2008. This is before advertising spend increase, S&A associated with new campuses and overall increased S&A spend for a growing organization (did we miss a round of layoffs during 2008 at ESI?).

There is another wrinkle. ESI is the only publicly traded for-profit postsecondary education company that capitalizes marketing costs. From their 2007 10-K filing:

Direct Marketing Costs. Direct costs incurred relating to the enrollment of new students are capitalized using the successful efforts method. The direct costs subject to capitalization are readily quantifiable and are not subject to estimation. Direct marketing costs subject to capitalization include salaries and employee benefits of recruiting representatives and other direct costs. Successful efforts is the ratio of students enrolled to prospective students interviewed. The higher the rate of interviewed students who enroll, the greater the percentage of our direct marketing costs that are capitalized. We amortize our direct marketing costs on a cost-pool-by-cost-pool basis over the period that we expect to receive revenue streams associated with those assets. The amortization method and period are based on historical trends of student enrollment and retention activity and are not subject to significant assumptions. We regularly evaluate the factors used to determine the amounts to be deferred and amortized and the future recoverability of those deferred costs.

Suffice to say, that capitalizing direct marketing costs would not be considered the most conservative accounting treatment, particularly during a period of rising marketing spend. However, it might give us an answer as to why S&A expense has been so low. Naturally, one would expect a sizeable increase in capitalized direct marketing costs. Direct Marketing cost as represented on the balance sheet did increase 11.7% YOY, but that's still well below the 15% growth in new enrollment counselors. Additionally, one would expect a higher rate of growth in capitalized direct marketing costs if the company is having greater success converting leads to enrollments. It is our understanding that the company had some one time benefits to S&A expense in 4Q08, but it has not disclosed what they were. That being said, one should expect less leverage on S&A expense in 2009 as enrollment counselor hiring costs roll through the P&L and bad-debt expense continues to increase.

The Repercussions and Remedies for ESI

It has been almost 20-years since the last major shake-out in the higher education space related to student loan defaults. We expect that we are heading into an environment where overall average cohort default rates could eclipse 10% and that for higher priced associate degree program providers could approach, if not eclipse 20%. It appears almost inevitable that some level of consumerism will be introduced into the higher education sector. Gone are the days where students are willing to take on $10,000's of debt to obtain a degree without a clear social benefit or quantifiable economic outcome. It is also highly likely in our view that the

government will take an extensive look at its policies, which have in part supported spiraling tuition prices.

In the case of ESI, we expect a few of their schools to be placed on provisional standing in conjunction with the release of cohort default date for 2008. Based on the severity and duration of this economic downturn, it is highly likely that default data for 2009, under the new methodology will also be quite high. In an environment of surging defaults, it is possible that many private lenders will back away from the government backed student loan program. Here are the likely repercussions for ESI over the next 2-3 years:

1. A greater likelihood of accessing the federal direct loan program
2. Brand damage due to negative press surrounding the level of defaults for graduates from the company's schools
3. Increased regulatory scrutiny (although school closures or loss of Title IV access altogether are less likely)
4. Slower working capital turns due to the timing of receipt of federal financial aid
5. More student financing from ESI's own balance sheet
6. Potential charges to earnings as a result of prior risk sharing agreements with private lenders
7. Increased investment in student counselors/retention programs
8. Further investment in collection advisors or third party collection agencies

The company is in a precarious situation and management remains oblivious to the crushing debt burdens the average ITT Tech graduate now faces. The three most important remedies the company must adopt are:

1. Increase admission standards
2. Improve program offerings to facilitate higher job placement
3. **Tuition Price cuts**

The first will result in a lower enrollment growth rate and the latter two, margin compression, but these are necessary steps to take if the company's long term viability is to remain intact. We estimate that ESI will need to cut tuition by approximately 15-20% in order to restore affordability of its programs to levels consistent with the earlier part of this decade when cohort default rates were at more reasonable levels. **We estimate that restoring the affordability of ESI's programs could negatively impact EPS by $2.50-$3.00 in 2010, maybe more.**

The more adroit management teams in the for-profit postsecondary education space have recognized that affordability is a vital lynchpin in the overall success of an educational institution. Unfortunately, for too long, the management teams have relied on the traditional academic sector to provide institutions a "tuition pricing

umbrella" to determine the cost of their programs, irrespective of the impact on economic returns for the student. As we have demonstrated, educational value for the for-profit postsecondary education sector is not difficult to determine, particularly for those that are offering students the prospects of job placement. ESI's management team needs to recognize that their business model has tremendous structural flaws that need to be addressed immediately.

PROBABILITY WEIGHTED RETURN

Looking at the return on investment based not only on current valuation, but the probability weighted return given our conviction level

Upside Conviction Level: 80%

A quick look at valuation: At 16.5x, ESI shares appear to reasonably valued, if not outright cheap for a stock with a robust ROE and strong EPS growth. The for-profit education sector currently trades at an average multiple of 23x FY1 EPS. The group has undergone some multiple compression in recent months due to concerns about rising bad-debt expense and cohort default rates.

Company	Ticker	Price	Shares Out	Mkt Cap	YTD Change	FY1 EPS	FY1 P/E	FY2 EPS	FY2 P/E	RSI	Price to Sales	FCF Yield	Price to Book
Apollo Group	APOL	$66.33	160.8	$10,668	-13.4%	$3.95	16.8x	$4.77	13.9x	45.08	2.7x	5.8%	8.4x
American Public Education	APEI	$40.30	18.0	$727	8.4%	$1.21	33.3x	$1.71	23.6x	58.87	4.8x	2.6%	13.6x
Capella Education Company	CPLA	$51.50	16.7	$862	-12.4%	$2.22	23.2x	$2.83	18.2x	66.49	2.6x	3.5%	6.1x
Career Education Corp.	CECO	$22.68	88.0	$1,997	26.4%	$1.10	20.6x	$1.57	14.4x	44.37	1.2x	7.4%	2.1x
Corinthian Colleges, Inc.	COCO	$18.42	49.8	$917	12.5%	$0.68	27.1x	$1.03	17.9x	51.69	0.7x	N/A	2.1x
DeVry, Inc.	DV	$46.38	71.6	$3,321	-19.2%	$2.23	20.8x	$2.80	16.6x	43.85	2.3x	4.1%	4.0x
Grand Canyon Education	LOPE	$15.95	45.5	$725	-15.1%	$0.55	29.0x	$0.85	18.8x	48.30	2.9x	0.3%	13.5x
ITT Educational Services, Inc.	**ESI**	**$108.67**	**39.1**	**$4,249**	**7.3%**	**$6.60**	**16.5x**	**$7.66**	**14.2x**	**49.00**	**3.5x**	**3.2%**	**22.6x**
Lincoln Educational Services, Inc.	LINC	$17.51	26.6	$466	32.2%	$0.95	18.4x	$1.15	15.2x	53.64	1.0x	7.3%	2.7x
Strayer Education Inc.	STRA	$186.33	14.1	$2,633	-13.1%	$6.99	26.7x	$8.62	21.6x	42.05	5.3x	2.6%	15.0x
			AVERAGE		**1.4%**		**23.2x**		**17.4x**	50.33	**2.7x**	**4.1%**	**9.0x**

Source: Yahoo finance

We think ESI shares could trade to $65-$70 over the next 12-months: At $65, ESI would trade at approximately 10x current FY09 consensus, which is consistent with the valuation levels the stock has been afforded during other periods of regulatory scrutiny or acute investor concerns about student financing.

Total Probability Weighted Return: In order to better allocate capital from a timing and sizing perspective, we think it is important to look at each position on a probability weighted return basis. Overall, we think there's an 80% chance that ESI shares will trade lower over the next 12-months. One of the bigger issues we face in making this recommendation at this time is that there are few, if any clearly identifiable catalysts for the stock in the near term. However, we think any additional upside in the stock is highly predicated on multiple expansion, which we view as unlikely given mounting concerns about student loan default rates and bad debt expense. We would use any upside movement in the stock over the next few quarters as an opportunity to exit long positions or increase the size of short positions.

Return Matrix	Current Price	Target Price	Conviction Level	Absolute Return	Holding Period	Annualized Return	Total Probability Weighted Return
Upside	$108.67	$65.00	55.0%	40.2%	1.0x	40.2%	21.7%
Base	$108.67	$95.00	25.0%	12.6%	1.0x	12.6%	
Downside	$108.67	$128.00	20.0%	-17.8%	1.0x	-17.8%	

Source: PAA Research LLC

HEDGING STRATEGIES TO CONSIDER

Choice of Hedge: We would use APOL as the primary hedge to any short position established in ESI. APOL shares now trade at a similar multiple to ESI, even though APOL has been considerably more cautious in raising tuition over the past several years and as a result will likely see lower levels of student loan defaults in the coming years. APEI could also be a good hedge. Despite its premium valuation the company appears less likely to experience significant issues with student loan defaults given the low price points for its program and stable funding sources.

Relevant upcoming events:	April 23	ESI reports 1Q09 results