Defying the Industry's Countercyclical Tendencies

Strayer Education, Inc.

by Ken Kavula

Editor's note: The following is an edited adaptation of an online stock study of Strayer Education, Inc. (ticker: STRA) conducted on Oct. 7 by Ken Kavula, chairman of the BetterInvesting Volunteer Advisory Board and longtime volunteer with the Mid-Michigan Chapter.

To view the entire presentation, go to the BetterInvesting homepage and look for the Online Stock Study Series box. Note that this presentation employed BetterInvesting's Online Stock Selection Guide and the Online SSG's new Preferred Procedure functionality. Much of the data comes from the end of Strayer's last fiscal year along with a Value Line report dated July 31.

This article is for educational purposes only. No investment recommendation is intended. Readers are urged to conduct their own stock study of any company of interest using their own judgments. Our thanks to Ken and the other volunteers for their participation in this event.

Strayer Education is a proprietary institution of higher education. It is accredited and was founded in 1892. Strayer primarily offers undergraduate and graduate degrees. A "proprietary institution of higher education" hires their own professors who then create unique courses and offer them to the students. Strayer is classified by Standard & Poor's as a consumer discretionary company, specifically in the educational services industry; Value Line places Strayer in the same industry.

Strayer makes the case that there's a lot of room for expansion in what they do. In the United States, there are about 187 million people over 25 years of age, and almost half of them are high school graduates with no further degree, and another 15 percent has less than a high school diploma. Only about a third of the population over 25 years of age has a college degree. That would include people with associate degrees.

The gap in wages between folks who have just a high school diploma and folks with just a bachelor's degree has widened considerably in the last 30 years. Back in 1979, folks with a bachelor's degree made about a third more than folks holding a high school diploma. Today, that gap has increased to 83 percent. This is another really good reason that Strayer feels there's a lot of room for growth.

Strayer has about 46,000 students on 71 different campuses in 15 states and Washington, D.C. Its focus is on working adults; you won't find many folks fresh out of high school attending Strayer University. There's a lot of geography left in the United States for Strayer to move into; it has no presence at all basically west of the Mississippi River and very little presence anywhere in New England.

Over half the degrees granted are bachelor's degrees with another quarter or so being master's degrees. Only 11 percent of Strayer's degrees are two-year associate degrees, with a small number of students who are undeclared or in other categories. Many of Strayer's competitors focus on associate degrees and certification programs; you won't see this high preponderance of bachelor's and master's programs at many of Strayer Education's direct for-profit competitors.

Strayer has some specific growth strategies. First, it wants to ensure stable performance in its mature markets. Strayer focuses a lot of its efforts on maintaining its student enrollment at campuses that are already open. Strayer also puts a lot of effort into opening new campuses. Their goal is to open somewhere between seven and nine new campuses every year; part of this goal is to penetrate states where there are currently no Strayer campuses.

They also plan to expand Strayer University online. The online enrollment has been very, very robust since the turn of the century. Back in 2001, Strayer had only about 2,500 students enrolled in online class offerings, and today that number is rapidly approaching 30,000 students.

Finally, Strayer is making a concerted effort to develop corporate and institutional alliances. Rather than being countercyclical, as with many of the educational institutions that do better when the economy gets worse because people go back to school, Strayer seems to be acyclical: It doesn't exhibit any signs of being a cyclical company at all, and the reason is these corporate and institutional alliances. When times are bad, Strayer gets a big increase in students because people go back to college to train, but when times are good, Strayer gets a lot of its students directly from corporate and institutional partners that are willing to pay for these students to increase their skills. Strayer seems to have found the key to erasing the cyclical nature of for-profit educational institutions.

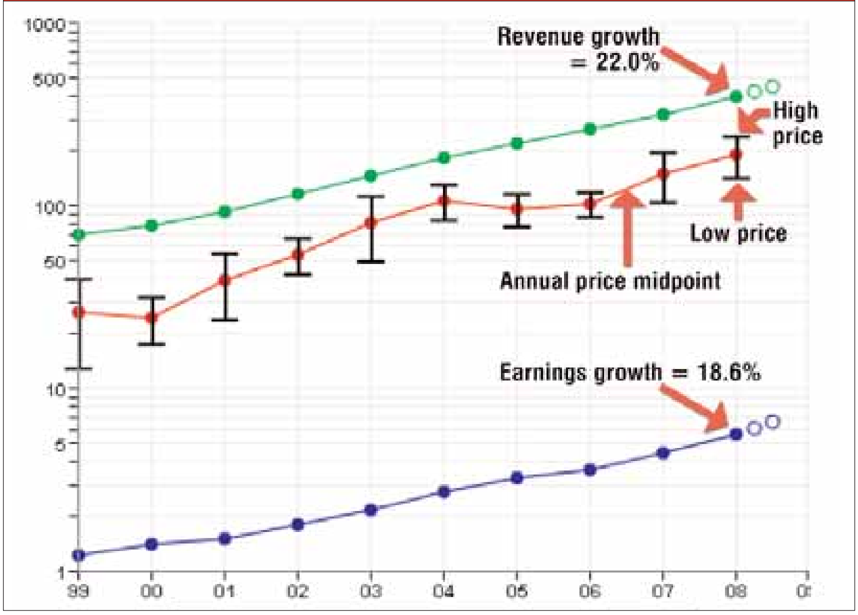
Before the turn of the century, Strayer's enrollment growth was pretty healthy, running just under 10 percent a year. But since about the year 2000, Strayer's enrollment has taken off, growing pretty regularly at 18 percent year after year after year. Strayer expects this enrollment growth to continue.

Strayer makes a big deal about distributable cash flow, which it defines as the cash generated from the operations of the business that is then available to distribute to owners after making all the necessary investments in the growth and maintenance of the business. You'll notice that over the last eight years, distributable cash flow in a couple of years has met or exceeded net income. This is a big plus, in my estimation.

Assessing Quality

So now let's discuss whether Strayer is a quality growth

Strayer's Sales & EPS Growth: Up, Straight and Parallel



Strayer High and Low P/Es

	High	Low
2004	47.4	30.5
2005	35.6	23.7
2006	32.3	24.1
2007	43.8	23.4
2008	42.3	25.1

stock. I'll start by looking at Strayer's revenues. I can tell they're consistent by the straightness of the green sales line on the Visual Analysis section of the Stock Selection Guide *(see graph, this page).* I have data going back to 1999. The line goes up and is straight; that is all that I could ask for from a good, solid growth company. I then look at the blue earnings-per-share line and notice a very similar type of graph. In between them are bars representing the high and low prices from any one of the given fiscal years. And then the red line tries to connect the midpoints of those I bars. I would love to see all three lines moving up: Up, straight and parallel is exactly what I'm looking for in a high-quality growth stock. I think Strayer Education exhibits those characteristics.

I now look at the pre-tax profit on sales. In the most recent fiscal year of 2008, Strayer earned a bit more than 33 cents on every dollar. I compare that with the five-year average, which is just under 34 cents. I think that's a pretty good comparison. I'd call it stable, and since that margin has been rising since 2006, and since it's a pretty healthy number, I'm pretty confident that this is what a good-quality growth stock should be showing me.

I then look at percent earned on equity and again, when I look at the 2008 number, 45 percent, and compare it with the five-year average of only 33 percent, things are looking real good to me. I also note that the trend in those numbers from 2004 through 2008 has been generally up. The company also has no debt. Just like I would love to have no debt in my personal life, I love it when the companies I'm studying, especially the smaller ones, don't carry any debt. There's no debt not only in the most recent fiscal year but also in the last five years or, for that matter, in the last 10 years.

My conclusion is that I'm looking at a very, very high-quality growth stock, so I'm going to continue the study. My next job is to try to determine what the profitability of the company is going to be.

Determining Sales and Earnings Growth

Since Strayer does have yearly revenues of less than $500 million, according to BetterInvesting this would be classified as a small-company stock. And when I'm studying a small stock, I expect revenue and earnings growth to exceed 15 percent a year. That's the benchmark I use if I'm going to assume the risk inherent in investing in smaller stocks. And at 22 percent for sales and almost 19 percent for earnings, Strayer does show me that kind of growth.

Amazingly, even though this is a small company, I find there's a regular Value Line report for the company and there's also an extensive Morningstar report. Both reports call for revenue and EPS growth in the high teens going forward. It's unusual to find these sources forecasting similar numbers.

This leads us to our first poll. What value do you think we should use for five-year revenue growth?

- 22 percent, the 10-year growth rate
- 21 percent, the five-year growth rate
- 22.8 percent, Value Line's estimate for the next three to five years
- 19 percent, Morningstar's estimate through 2013
- Some other value

(The participants select 19 percent.) Since I'm doing the SSG and am going to be choosing the numbers, I finally settled on a slightly lower number after reading some other sources. I'm going to be using 18 percent, but I don't think I'd have any argument with somebody who wanted to use 19 percent or even 20 percent or with somebody who wanted to be slightly more conservative. I think we all agree that Strayer's growth is extremely healthy and it's going to be in the high teens and perhaps even in the low 20s going forward.

Now let's launch our second poll. What value should we use for the future five-year EPS growth?

- 20 percent, the analysts' consensus estimate
- 18.6 percent, the 10-year rate
- 24.6 percent, Value Line's estimate for the next three to five years

- 19 percent, the value generated by using Preferred Procedure
- Some other value

(The participants select 19 percent.) Well, that must be absolutely correct because it's my choice also. I tend to make a lot of use of the Preferred Procedure. After all, there must be some reason why it was called preferred in the first place.

Studying Valuation

I'm looking now at high price-earnings ratios and I'm paying special attention to the last five years' P/E values. They're extremely aggressive *(see table, page 43)*. In the Mid-Michigan Chapter, we teach our students to gasp at numbers when they get this high. My problem is that I'm going to have to determine what I think the high P/E will be going forward. Of course, I'm looking for trends, I'm checking current P/E values, I'm reminding myself about my own comfort value. I'm doing the same thing on the low side. The five-year low numbers are on the high side for a lot of our corporations.

I'm going to multiply the P/E by an earnings number and that's going to give me a price value. So multiplying a high P/E ratio by an estimated high earnings number based on the growth rate that I chose gives me an estimated high price, with the same thing happening on the low side.

So what number would you like to use for the high P/E?

- 40.4, the five-year average high
- 38.3, the 10-year average high
- 42.6, the two-year average high
- 42.3, the high in the most recent year
- Some other value

I'll give you a hint. I'm not going to use any of the first four numbers. *(The participants select "some other value.")* I'm not going to go as low as some of you might want me to for the high P/E. I am going to choose 35; I hardly ever go above the high 20s on the high side, but with the growth rate I'm forecasting, I think a P/E of 35 might just be something that sets the limit going forward.

Remember that I'm also going to multiply the low P/E by a low EPS. I'm going to use the last four quarters' number of $6.61 for the low EPS. For our last poll, we'll decide what we'd like to use for a low P/E:

- 25.3, the five-year average low
- 21.1, the 10-year average low
- 24.2, the two-year average low
- 25.1, the low in the most recent year
- Some other value

(The participants select 21.1.) I'm going to be a little more frisky than that and choose the most recent low P/E of 25.1. And just to keep things simple so that we can remember it in our head, I'm going to make that 25 going forward. With a high P/E of 35 and a low P/E of 25, the average I've chosen is around 30. When I look at Value Line's historical numbers, with average P/Es ranging between 16.7 and 40.5, and its projected average P/E of 29 in the next three to five years, I'm pretty comfortable with my call of 30 for the next five years.

Forecasting Return

The last thing I have to worry about is percentage payout of EPS as a dividend. Strayer does pay a pretty nice dividend, and in 2007 it paid a significant special dividend. So as I try to figure the payout ratio, I'm going to eliminate that 74 percent in 2007 and look at the four-year average of 23 percent. After examining the numbers, especially the most current ones, I settle on a payout ratio of around 28 percent, which gives me a yield of around 0.8 percent. That 0.8 percent certainly fits into the most recent history and is consistent with the number Value Line is predicting going forward.

Remember, I've chosen a high P/E of 35. My 19 percent growth gives me $13.53 for the EPS five years from now. When I multiply 35 by $13.53, I find that five years from now, this stock might be trading as high as $473. It was trading at $215 at the close of the market today.

Then when I multiply my low P/E of 25 by the most recent four quarters' EPS of $6.61, I get a conceivable low price five years from now of somewhere around $165. Again, I compare that to the current price and I'm perfectly comfortable with that number as the low price.

Let's determine the potential gain vs. loss. My upside-downside ratio is 4.5 to 1, which is greater than the 3 to 1 I look for, and I'm in the Buy zone.

Finally, I determine the five-year return potential. If I were to sell the stock five years from now at a P/E of 35 — the high P/E that I chose — the rate of return would be 17.3 percent a year. If I were to sell Strayer five years from now at the average P/E that I chose of 30, I stand to make around 13.9 percent. I like to think of my return as somewhere in between these two numbers. I would hope that I could sell Strayer somewhere above the average P/E I forecast and hope the P/E would be approaching that high of 35. B

Online SSG Tutorial

If you haven't used BetterInvesting's Web-based Online Stock Selection Guide in a while, we think you should learn about the free updates made to the tool by the Online Tools Committee and BetterInvesting developers. In a tutorial webinar, we'll discuss new features such as the Preferred Procedure option, peer comparison and outlier selection.

This tutorial will cover the basic operation of the Online SSG — from selecting a stock to completing the SSG and analyzing the projected return — as well as using some of the tool's most popular features.

All BetterInvesting members, even those currently without access to the Online SSG, are welcome to attend the webinar. The webinar will be from 8 p.m. to 9:15 p.m. on Thursday, Jan. 21. Sign up for the webinar at www.betterinvesting.org/onlinetools.

By the way, BetterInvesting now offers a free trial version of the Online SSG to help spread the word about fundamental stock analysis to your family and friends. We'll talk more about the trial version at the webinar.