

ITT EDUCATIONAL SERVICES INC

Form 10-Q

April 26, 2013

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended March 31, 2013

OR

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 1-13144

**ITT EDUCATIONAL SERVICES, INC.**

(Exact name of registrant as specified in its charter)

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**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**36-2061311**  
(I.R.S. Employer  
Identification No.)

**13000 North Meridian Street**

**Carmel, Indiana**  
(Address of principal executive offices)

**46032-1404**  
(Zip Code)

**Registrant's telephone number, including area code: (317) 706-9200**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company)

Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

**23,362,123**

Number of shares of Common Stock, \$.01 par value, outstanding at March 31, 2013

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**ITT EDUCATIONAL SERVICES, INC.**

Carmel, Indiana

Quarterly Report to Securities and Exchange Commission

March 31, 2013

**PART I**

**FINANCIAL INFORMATION**

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Condensed Consolidated Statements of Comprehensive Income (unaudited) for the three months ended March 31, 2013 and 2012

Condensed Consolidated Statements of Cash Flows (unaudited) for the three months ended March 31, 2013 and 2012

Condensed Consolidated Statements of Shareholders' Equity for the three months ended March 31, 2013 and 2012 (unaudited) and the year ended December 31, 2012

Notes to Condensed Consolidated Financial Statements

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**Table of Contents****ITT EDUCATIONAL SERVICES, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS**

(Dollars in thousands, except per share data)

	March 31, 2013 (unaudited)	As of December 31, 2012	March 31, 2012 (unaudited)
<b>Assets</b>			
Current assets:			
Cash and cash equivalents	\$ 210,012	\$ 246,342	\$ 178,476
Short-term investments	0	0	114,806
Restricted cash	719	601	1,123
Accounts receivable, net	104,077	77,313	54,411
Deferred income taxes	29,513	44,547	12,566
Prepaid expenses and other current assets	18,651	16,162	17,832
<b>Total current assets</b>	<b>362,972</b>	<b>384,965</b>	<b>379,214</b>
Property and equipment, net	184,123	189,890	198,493
Deferred income taxes	56,858	56,112	34,081
Other assets	39,033	41,263	49,516
<b>Total assets</b>	<b>\$ 642,986</b>	<b>\$ 672,230</b>	<b>\$ 661,304</b>
<b>Liabilities and Shareholders' Equity</b>			
Current liabilities:			
Accounts payable	\$ 63,713	\$ 63,304	\$ 77,664
Accrued compensation and benefits	15,425	21,023	13,323
Other current liabilities	34,807	86,722	50,920
Deferred revenue	120,628	135,900	180,147
<b>Total current liabilities</b>	<b>234,573</b>	<b>306,949</b>	<b>322,054</b>
Long-term debt	150,000	140,000	175,000
Other liabilities	100,138	98,327	72,629
<b>Total liabilities</b>	<b>484,711</b>	<b>545,276</b>	<b>569,683</b>
Shareholders' equity:			
Preferred stock, \$.01 par value, 5,000,000 shares authorized, none issued	0	0	0
Common stock, \$.01 par value, 300,000,000 shares authorized, 37,068,904 issued	371	371	371
Capital surplus	204,219	206,703	194,027
Retained earnings	990,202	959,072	884,230
Accumulated other comprehensive (loss)	(7,835)	(7,930)	(9,316)
Treasury stock, 13,706,781, 13,744,395 and 12,934,377 shares, at cost	(1,028,682)	(1,031,262)	(977,691)
<b>Total shareholders' equity</b>	<b>158,275</b>	<b>126,954</b>	<b>91,621</b>
<b>Total liabilities and shareholders' equity</b>	<b>\$ 642,986</b>	<b>\$ 672,230</b>	<b>\$ 661,304</b>

The accompanying notes are an integral part of these condensed consolidated financial statements.



**Table of Contents****ITT EDUCATIONAL SERVICES, INC.****CONDENSED CONSOLIDATED STATEMENTS OF INCOME**

(Amounts in thousands, except per share data)

(unaudited)

	<b>Three Months Ended March 31,</b>	
	<b>2013</b>	<b>2012</b>
<b>Revenue</b>	\$ 287,711	\$ 341,794
<b>Costs and expenses:</b>		
Cost of educational services	125,221	134,941
Student services and administrative expenses	106,282	106,266
Loss related to private student loan programs	3,464	0
Total costs and expenses	234,967	241,207
<b>Operating income</b>	52,744	100,587
Interest income	34	681
Interest (expense)	(1,152)	(547)
Income before provision for income taxes	51,626	100,721
Provision for income taxes	20,496	39,650
<b>Net income</b>	\$ 31,130	\$ 61,071
<b>Earnings per share:</b>		
Basic	\$ 1.33	\$ 2.40
Diluted	\$ 1.33	\$ 2.38
<b>Weighted average shares outstanding:</b>		
Basic	23,397	25,420
Diluted	23,481	25,636

The accompanying notes are an integral part of these condensed consolidated financial statements.

**Table of Contents****ITT EDUCATIONAL SERVICES, INC.****CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME****(Dollars in thousands)****(unaudited)**

	<b>Three Months Ended</b>	
	<b>March 31,</b>	
	<b>2013</b>	<b>2012</b>
<b>Net Income</b>	<b>\$ 31,130</b>	<b>\$ 61,071</b>
<b>Other comprehensive income, net of tax:</b>		
Net actuarial pension loss amortization, net of income tax of \$211 and \$272	333	423
Prior service cost (credit) amortization, net of income tax of \$151 and \$151	(238)	(237)
Unrealized (losses) on available-for-sale securities, net of income tax of \$0 and \$0	0	(23)
Other comprehensive income, net of tax	95	163
<b>Comprehensive income</b>	<b>\$ 31,225</b>	<b>\$ 61,234</b>

The accompanying notes are an integral part of these condensed consolidated financial statements.

**Table of Contents****ITT EDUCATIONAL SERVICES, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(Dollars in thousands)

(unaudited)

	<b>Three Months Ended March 31,</b>	
	<b>2013</b>	<b>2012</b>
<b>Cash flows from operating activities:</b>		
Net income	\$ 31,130	\$ 61,071
Adjustments to reconcile net income to net cash flows from operating activities:		
Depreciation and amortization	7,292	7,420
Provision for doubtful accounts	19,885	15,601
Deferred income taxes	13,211	(3,742)
Excess tax benefit from stock option exercises	0	(805)
Stock-based compensation expense	3,093	4,483
Settlement cost	(46,000)	0
Other	294	(339)
Changes in operating assets and liabilities:		
Restricted cash	(118)	1,005
Accounts receivable	(46,649)	(21,906)
Accounts payable	409	(1,212)
Other operating assets and liabilities	(10,693)	22,166
Deferred revenue	(15,272)	(46,396)
Net cash flows from operating activities	(43,418)	37,346
<b>Cash flows from investing activities:</b>		
Facility expenditures and land purchases	(100)	(132)
Capital expenditures, net	(1,418)	(4,518)
Proceeds from sales and maturities of investments and repayment of notes	215	98,955
Purchase of investments and note advances	(1,241)	(63,545)
Net cash flows from investing activities	(2,544)	30,760
<b>Cash flows from financing activities:</b>		
Excess tax benefit from stock option exercises	0	805
Proceeds from exercise of stock options	0	4,668
Debt issue costs	0	(1,525)
Proceeds from revolving borrowings	10,000	175,000
Repayment of revolving borrowings	0	(150,000)
Repurchase of common stock and shares tendered for taxes	(368)	(147,571)
Net cash flows from financing activities	9,632	(118,623)
Net change in cash and cash equivalents	(36,330)	(50,517)
Cash and cash equivalents at beginning of period	246,342	228,993
<b>Cash and cash equivalents at end of period</b>	<b>\$ 210,012</b>	<b>\$ 178,476</b>

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The accompanying notes are an integral part of these condensed consolidated financial statements.

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## ITT EDUCATIONAL SERVICES, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

(Dollars and shares in thousands)

	Common Stock		Capital	Retained	Accumulated	Common Stock in		Total
	Shares	Amount	Surplus	Earnings	Other	Shares	Amount	
					Comprehensive			
					Income/(Loss)			
<b>Balance as of December 31, 2011</b>	37,069	\$ 371	\$ 189,573	\$ 827,675	(\$ 9,479)	(10,969)	(\$ 839,341)	\$ 168,799
For the three months ended March 31, 2012 (unaudited):								
Net income				61,071				61,071
Other comprehensive income, net of income tax					163			163
Equity award vesting and exercises				(4,515)		145	9,183	4,668
Tax benefit from equity award vesting and exercises			417					417
Stock-based compensation			4,037					4,037
Common shares repurchased						(2,097)	(146,657)	(146,657)
Issuance of shares for Directors compensation				(1)		1	38	37
Shares tendered for taxes						(14)	(914)	(914)
<b>Balance as of March 31, 2012</b>	37,069	371	194,027	884,230	(9,316)	(12,934)	(977,691)	91,621
For the nine months ended December 31, 2012 (unaudited):								
Net income				79,394				79,394
Other comprehensive income, net of income tax					1,386			1,386
Equity award vesting and exercises				(4,552)		127	8,229	3,677
Tax benefit from equity award vesting and exercises			501					501
Stock-based compensation			12,175					12,175
Common shares repurchased						(929)	(61,261)	(61,261)
Shares tendered for taxes						(8)	(539)	(539)
<b>Balance as of December 31, 2012</b>	37,069	371	206,703	959,072	(7,930)	(13,744)	(1,031,262)	126,954
For the three months ended March 31, 2013 (unaudited):								
Net income				31,130				31,130
Other comprehensive income, net of income tax					95			95
Equity award vesting			(2,948)			59	2,948	0
Tax benefit from equity award vesting			(2,629)					(2,629)
Stock-based compensation			3,093					3,093
Shares tendered for taxes						(22)	(368)	(368)
<b>Balance as of March 31, 2013</b>	37,069	\$ 371	\$ 204,219	\$ 990,202	(\$ 7,835)	(13,707)	(\$ 1,028,682)	\$ 158,275

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The accompanying notes are an integral part of these condensed consolidated financial statements.

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**ITT EDUCATIONAL SERVICES, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**March 31, 2013**

**(Dollars in thousands, except per share data and unless otherwise stated)**

**1. The Company and Basis of Presentation**

We are a leading proprietary provider of postsecondary degree programs in the United States based on revenue and student enrollment. As of March 31, 2013, we were offering master, bachelor and associate degree programs to approximately 61,000 students at ITT Technical Institute and Daniel Webster College locations. In addition, we offered one or more of our online programs to students who are located in 48 states. As of March 31, 2013, we had 149 college locations (including 147 campuses and two learning sites) in 39 states. All of our college locations are authorized by the applicable education authorities of the states in which they operate and are accredited by an accrediting commission recognized by the U.S. Department of Education ( ED ). We have provided career-oriented education programs since 1969 under the ITT Technical Institute name and since June 2009 under the Daniel Webster College name. Our corporate headquarters are located in Carmel, Indiana.

The accompanying unaudited condensed consolidated financial statements include our wholly-owned subsidiaries accounts and have been prepared in accordance with generally accepted accounting principles in the United States of America for interim periods and pursuant to the rules and regulations of the U.S. Securities and Exchange Commission ( SEC ). Certain information and footnote disclosures, including significant accounting policies, normally included in a complete presentation of financial statements prepared in accordance with those principles, rules and regulations have been omitted. The Condensed Consolidated Balance Sheet as of December 31, 2012 was derived from audited financial statements but, as presented in this report, may not include all disclosures required by accounting principles generally accepted in the United States. Arrangements where we may have a variable interest in another party are evaluated in accordance with the provisions of Financial Accounting Standards Board ( FASB ) Accounting Standards Codification ( ASC or Codification ) 810, Consolidation ( ASC 810 ), to determine whether we would be required to include the financial results of the other party in our consolidated financial statements. Based on our most recent evaluation, we were not required to include the financial results of any variable interest entity in our condensed consolidated financial statements. See Note 8 Variable Interests, for additional discussion of our variable interests.

In the opinion of our management, the financial statements contain all adjustments necessary to fairly state our financial condition and results of operations. The interim financial information should be read in conjunction with the audited consolidated financial statements and notes thereto contained in our Annual Report on Form 10-K as filed with the SEC for the year ended December 31, 2012.

**2. New Accounting Guidance**

In February 2013, the FASB issued Accounting Standards Update ( ASU ) No. 2013-02, which is included in the Codification under ASC 220, Other Comprehensive Income ( ASC 220 ). This update requires an entity to report the effect, by component, of significant reclassifications out of accumulated other comprehensive income on the respective line items in net income. This guidance is effective for interim and annual reporting periods beginning January 1, 2013. The adoption of this guidance requires that we provide additional disclosures regarding the amounts reclassified out of accumulated other comprehensive income during the reporting period. We have included these disclosures in the footnotes to our condensed consolidated financial statements.

In October 2012, the FASB issued ASU No. 2012-04, which makes technical corrections, clarifications and limited-scope improvements to various topics throughout the Codification. The amendments in this ASU that do not have transition guidance are effective upon issuance and the amendments that are subject to transition guidance are effective for our interim and annual reporting periods beginning January 1, 2013. The adoption of this guidance did not have a material impact on our condensed consolidated financial statements.

In July 2012, the FASB issued ASU No. 2012-02, which is included in the Codification under ASC 350, Intangibles Goodwill and Other ( ASC 350 ). This update allows an entity to first assess qualitative factors to determine whether it must perform a quantitative impairment test. An entity would be required to calculate the fair value of an indefinite-lived intangible asset, if the entity determines, based on a qualitative assessment, that it is more likely than not that the indefinite-lived asset is impaired. This guidance is effective for impairment tests performed for our interim and annual reporting periods beginning January 1, 2013. The adoption of this guidance did not have a material impact on our

condensed consolidated financial statements.

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In December 2011, the FASB issued ASU No. 2011-11, which is included in the Codification under ASC 210, Balance Sheet (ASC 210). This update provides for enhanced disclosures to help users of financial statements evaluate the effect or potential effect of netting arrangements on an entity's financial position. In January 2013, the FASB issued ASU No. 2013-01, which clarifies the scope of the disclosures required under ASU No. 2011-11. Both of these updates are effective for interim and annual reporting periods beginning January 1, 2013. The adoption of this guidance did not have a material impact on our condensed consolidated financial statements.

**3. Fair Value**

Fair value for financial reporting is defined as the price that would be received upon the sale of an asset or paid upon the transfer of a liability in an orderly transaction between market participants at the measurement date. The fair value measurement of our financial assets utilized assumptions categorized as observable inputs under the accounting guidance. Observable inputs are assumptions based on independent market data sources.

The following table sets forth information regarding the fair value measurement of our financial assets as of March 31, 2013:

Description	As of March 31, 2013	Fair Value Measurements at Reporting Date Using		
		(Level 1) Quoted Prices in Active Markets for Identical Assets	(Level 2) Significant Other Observable Inputs	(Level 3) Significant Unobservable Inputs
Cash equivalents:				
Money market fund	\$ 208,212	\$ 208,212	\$ 0	\$ 0
Other assets:				
Money market fund	8,623	8,623	0	0
	\$ 216,835	\$ 216,835	\$ 0	\$ 0

We used quoted prices in active markets for identical assets as of the measurement date to value our financial assets that were categorized as Level 1.

The carrying amounts for cash and cash equivalents, restricted cash, accounts receivable, accounts payable, other current liabilities and deferred revenue approximate fair value because of the immediate or short-term maturity of these financial instruments. Investments classified as available-for-sale as of March 31, 2012 were recorded at their market value.

Each of the carrying value and the estimated fair value of the notes receivable and other receivables included in Prepaid expenses and other current assets or Other assets on our Condensed Consolidated Balance Sheet was approximately \$9,500 as of March 31, 2013, \$9,600 as of December 31, 2012 and \$19,000 as of March 31, 2012. We estimated the fair value of the notes receivable and other receivables by discounting the future cash flows using current rates for similar arrangements. The assumptions used in this estimate are considered unobservable inputs. Fair value measurements that utilize significant unobservable inputs are categorized as Level 3 measurements under the accounting guidance.

Each of the carrying value and estimated fair value of our long-term debt was approximately \$150,000 as of March 31, 2013, \$140,000 as of December 31, 2012 and \$175,000 as of March 31, 2012. The fair value of our long-term debt was estimated by discounting the future cash flows using current rates for similar loans with similar characteristics and remaining maturities. We utilized inputs that were observable or were principally derived from observable market data to estimate the fair value of our long-term debt. Fair value measurements that utilize significant other observable inputs are categorized as Level 2 measurements under the accounting guidance.

**4. Equity Compensation**

The stock-based compensation expense and related income tax benefit recognized in our Condensed Consolidated Statements of Income in the periods indicated were as follows:

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	<b>Three Months Ended</b>	
	<b>March 31,</b>	
	<b>2013</b>	<b>2012</b>
Stock-based compensation expense	\$ 3,093	\$ 4,483
Income tax (benefit)	(\$ 1,191)	(\$ 1,726)

We did not capitalize any stock-based compensation cost in the three months ended March 31, 2013 or 2012.

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As of March 31, 2013, we estimated that pre-tax compensation expense for unvested stock-based compensation grants in the amount of approximately \$16,000 net of estimated forfeitures, will be recognized in future periods. This expense will be recognized over the remaining service period applicable to the grantees which, on a weighted-average basis, is approximately 1.6 years.

The stock options granted, forfeited, exercised and expired in the period indicated were as follows:

	# of Shares	Three Months Ended March 31, 2013		Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value (1)
		Weighted Average Exercise Price	Aggregate Exercise Price		
Outstanding at beginning of period	1,574,604	\$ 84.90	\$ 133,691		
Granted	0	\$ 0	0		
Forfeited	(2,667)	\$ 74.99	(200)		
Exercised	0	\$ 0	0		
Expired	(197,244)	\$ 47.59	(9,387)		
Outstanding at end of period	1,374,693	\$ 90.28	\$ 124,104	3.1	\$ 0
Exercisable at end of period	1,225,187	\$ 92.37	\$ 113,170	2.8	\$ 0

- (1) The aggregate intrinsic value of the stock options was calculated by identifying those stock options that had a lower exercise price than the closing market price of our common stock on March 28, 2013 and multiplying the difference between the closing market price of our common stock and the exercise price of each of those stock options by the number of shares subject to those stock options that were outstanding or exercisable, as applicable.

The following table sets forth information regarding the stock options granted and exercised in the periods indicated:

	Three Months Ended March 31,	
	2013	2012
Shares subject to stock options granted	0	156,500
Weighted average grant date fair value per share	\$ 0	\$ 31.36
Shares subject to stock options exercised	0	104,054
Intrinsic value of stock options exercised	\$ 0	\$ 2,489
Proceeds received from stock options exercised	\$ 0	\$ 4,668
Tax benefits realized from stock options exercised	\$ 0	\$ 864

The intrinsic value of a stock option is the difference between the fair market value of the stock and the option exercise price.

The fair value of each stock option grant was estimated on the date of grant using the following assumptions:

	Three Months Ended March 31,	
	2013	2012
Risk-free interest rates	Not applicable	0.7%
Expected lives (in years)	Not applicable	4.5
Volatility	Not applicable	51%
Dividend yield	Not applicable	None



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The following table sets forth the number of restricted stock units ( RSUs ) that were granted, forfeited and vested in the period indicated:

**Three Months  
Ended  
March 31, 2013**