

Addressing the Political Risks of Investing in the School Improvement Industry



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www.edbizbuzz.com

K-12Leads & Youth Service Markets Report

New Education Economy®

School Improvement Industry Week • The Podcast

Conclusions

- Political risk dominates the market
- Don't enter the space without:
 - A belief in the primacy of innovation
 - A belief in the political potential to make it so
 - A willingness to engage in politics
- Don't invest in a firm without:
 - Understanding its specific political vulnerabilities
 - Satisfactory programmatic competence
 - Management capacity to assess/manage political risk

Elements of Political Risk

- Government decisions and actions
- Material impact on business objectives
- Beyond the influence of individual firms

Descriptions of the “School Improvement” Industry

- Highly segmented marketplace of about \$25 billion
- Programs helping public education do better with student performance
- Sale of outcomes rather than inputs
- Reconfiguration of “teaching and learning” and supporting functions
- Competitor with multinational publishers and local professionals
- A political threat to many interests, a political opportunity to some

Paradox of Investment in School Improvement

- Great potential by any objective measure
- Field littered with disappointed investors

WHY?

- Failure to address political risk
- Seductive nature of political opportunity

Not a Paradox - a Trap

- **Political opportunity appeals to an investor's vision**
 - 1990s: driven by charters, standards, “new economy”
 - 2000s: interest reawakened by No Child Left Behind
- **Political risk taxes an investor's business judgment**
 - Works on federal, state and local levels
 - Involves legislation, regulation, action and funding
 - Affects core firm activities that are not well-understood
 - Places a premium on **experience addressing this risk**

Public Education Differs from Other Domestic Investment Markets in U.S.

- Opening a sector of the economy owned by the state
- Allowable purchases are set by law and regulation
- Pitch of better outcomes through joint action is new
- State of the evaluation art is crude
- Legal regime is balkanized and uncertain
- Federal regulation is arbitrary, process is vague
- Support for industry is passive, opposition is active

Political Risk Dominates this Industry

	PROGRAM RISK	PLAN RISK	FIRM RISK	POLITICAL RISK
ENTER THE MARKET	Green dotted pattern	Yellow dotted pattern	Green dotted pattern	Green dotted pattern
CRACK THE MARKET CODE	Hard (Yellow dotted pattern)	Green dotted pattern	Yellow dotted pattern	Red solid color
SURVIVE MARKET FRICTION	Harder (Orange dotted pattern)	Orange dotted pattern	Orange dotted pattern	Red solid color
SCALE FOR MARKET SHARE	Hardest (Red solid color)	Red solid color	Orange dotted pattern	Red solid color

A Sober View of the Investment Opportunity

- Barriers to an entrenched k-12 market appear breachable
 - Elite dissatisfaction with student performance
 - Splits in constituencies traditionally supportive of school system
 - Shaky coalitions pass new legislation inviting private enterprise
- Competing with a system
 - Against buyers as well as sellers
 - Against a broad, decentralized culture with deep roots
- Davids in a world of Goliaths
 - Selling performance in the face of brand
 - Outgunned in marketing
- Tending to “business risk” is not enough for a good harvest

SES: A Case Study in Three Acts

- Act I: “If it’s too good to be true...”
 - NCLB Sec. 1116(e)(6) implies \$1.2 billion opportunity
 - Requires big investment to preempt likely competitors
 - Sec. 1111(B), 1116(e)(2), 9401 risk potential ignored
- Act II: “You screwed-up. You trusted us”
 - Federal: We have to keep this pot from boiling over
 - State: Your problems are the least of our worries
 - Districts: We will resist by all available means
 - Firms: Who will bell the cat?

Act III: “Haven’t I Been Here Before?”

- K-12 systems’ resistance dooms **new** industry to margins
- Management energy spent defending existing locations
- Slower growth, similar burn rate
- Close substitutes/rivals pick and hold safe beachheads
- Investors pressure firms to “make plan”
- Management becomes willing to risk more for less
- Media “cherry picks” disadvantageous stories
- Public opinion remains skeptical
- Political supporters at center begin “distancing”
- Investor expectations’ head south... exit strategies narrow
- Investors become disenchanted and gun shy

Other Recent Examples

From www.edbizbuzz.com and *New Education Economy*—

- Implementation of Reading First
- Changing CA Instructional Materials Adoption
- A Look into District Professional Services
- Calculating Payments to Virtual Charters

Amending Title 5, CA Code of Regulations: Instructional Materials

Software & Information
Industry Association
www.siaa.net



March 13, 2007

Debra Strain
Regulations Coordinator, Legal Division
California Department of Education
1430 N Street, Room 5319
Sacramento, California 95814

Dear Ms. Strain:

On behalf of the Software & Information Industry Association (SIIA), I write to submit comments in response to the January 19, 2007 Notice of Proposed Rulemaking: Amendment to Title 5, California Code of Regulations, Regarding Instructional Materials.

“...the system employed in California to review and approve K-8 instructional materials – originally designed for print-based materials – does not sufficiently address opportunities and realities of technology-based instructional materials. ...

While California allows for inclusion of such electronic resources in their definition of instructional materials, **rules and processes**... often result in... exclusion.... These include provisions that adopted instructional materials:

- remain unchanged... for the adoption period....”

3/29/07

March 18, 2007... Kent Fischer

“Close relationships between district employees and the consultants they hire have long been common.... DISD spends... \$29 million on "professional service" contracts.... \$11 million goes to academic consultants... curriculum writers, mentors for teachers... after-school program managers.... Federal grants pay for most....

When district leaders began examining the deals, they found...

- ... [C]ontracts were rarely subject to competitive bidding.
- Hundreds of former employees... returned... as... consultants....
- A loose budgeting process allowed administrators to tuck away money for consultants without justifying the expense.”

Reading First: Arbitrary Implementation



“[S]tates reported to us several instances in which Reading First officials or contractors appeared to intervene to influence their selection.... [F]our states reported receiving suggestions from Education or its contractors to adopt specific reading programs.... [T]wo states reported that it was suggested that they adopt a particular reading assessment. (In) one instance... Reading First officials at Education worked in concert with state consultants to ensure that a particular reading program was included on that state’s list of approved reading programs.... (Ten) states reported receiving suggestions that they eliminate specific programs.... In another instance, state officials pointed out that they had adopted a program that was approved by other states.... but were told by Education officials that it should be removed from... and that Education would... take a similar course... with... those other states...”

Virtual School Finance: “Gotcha” v. Resolution of Facts



Audit: “Kern County.... contracted with MGT... to perform a limited scope audit... of the California Virtual Academy at Kern County (CAVA).... CAVA overclaimed approximately \$1 million in state revenues.... (and) misstated... its own pupil-to-teacher ratio and the... threshold it needed... for full funding....”

Response: “Although we requested an additional two weeks... in order to verify the underlying data... MGT... denied that request.... Historically there has been difficulty statewide... to determine... (the) ratio.... CDE and the Advisory Commission on Charter Schools... could not... determine the... ratio... under SB 740.... Recognition of that... is important to... under scoring the difficult position of CAVA to determine its own ... ratio.... [T]he report fails to recognize CAV for its “good faith effort” to report data openly and correctly... the standard used... to evaluate whether an auditee substantially complied....”

Avoid the Trap

- Think of this as a domestic version of Eastern Europe
- Check your own ideology and politics at the door
- Invest for long haul and underlying program value
- Learn and monitor this market's major features
- Don't follow pack to trendy market segments, look at firms
- Refine the template of your ideal investment
- Develop means to address investments' political risks
- Start smaller - better opportunities/same challenges

Assessing Market's Political Risk Features

Feature	Definition	Example	Investor Response
“Condition”	Managed, not solved	District budgets	Seek balance in sales plans
“Trend”	Consistent constraint or opportunity	Easing of AYP	Avoid new curriculum
“Unfinished Business”	Could be a watershed	SBR regulation	Seek firms that value evaluation
“Watershed”	Creates a new reality	GASB 45	Seek “efficiency” offerings

Assessing the Political Risk Profile of Potential Investments

Preferred	Not a Plus	Examples
Responds to <u>Many Trends</u>	One Trend	Educational Impact v. TeachFirst
Firm with <u>Competencies</u>	Just Products	Carnegie Learning v. Ignite
Many Funding <u>Sources</u>	One Source	Learning.com v. Platform Learning
<u>Required</u> School Activity	Discretionary	Touchstone v. Learning Through Sports
<u>No Threat</u> to Schools' Self Image	Direct Threat	Blackboard v. Edison
<u>Embedded in</u> Value Chain	Detachable from	SchoolNet v. Zaner-Bloser
Based on Human Capital <u>Shortage</u>	Abundance	Caveon v. SchoolWorkSite
Perceived to Work " <u>For</u> " System	"Against"	Opportunities for Learning v. White Hat
<u>Avoids</u> Political Risk	Incites	Huntington v. Ed. Alternatives Inc.
<u>Attentive to</u> Industry-Wide Issues	Not Interested in	???? v. Most firms
<u>Institutional</u> Relationships	Personal or Political	MAXIMUS v. Leapfrog or K12
Evaluation as a <u>Core Value</u>	Marketing	Edison v. Most Firms
<u>Franchised</u> Operation	Centralized	Sylvan Learning v. SCORE!
<u>Smaller/Older</u>	Bigger/Newer	Searchsoft v. Simplexis

Post-Investment: Managing Political Risk Becomes Investor's Problem Too

- Influences investors' exit strategy "BATNA"
- Area where investor "help" won't "get in the way"
- Investor has luxury of a longer/broader view
- Investor positioned to induce firm cooperation
- Expertise should be part of investor's "value-add"

Investors' "To Do" List for Managing Political Risk

- Consolidate Balkanized Trade Groups
 - EIA, SIAA, NCEP, NEKIA etc.
- Press New Association to Develop Substantive Capacity
 - Regulatory Policy
 - Program Evaluation Expertise
 - Lobbying
 - Communications
- Expect Investees to Participate
 - Make One Management Team Member Responsible
 - Spend a Little to Keep Up with Relevant Policies

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