

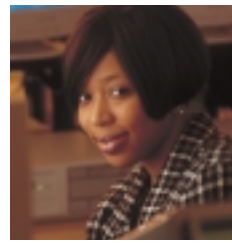
ITT EDUCATIONAL SERVICES, INC.
1998 ANNUAL REPORT



Wired



Inspired



Hired

Proven concept
 +
 Increased market demand
 +
 Limited competition
 +
 Barriers to entry
 +
 The right people

Increased shareholder value

SHAREHOLDERS' INFORMATION

Financial information about ITT Educational Services, Inc. and the annual report to the Securities and Exchange Commission on Form 10-K are available without charge (except for certain exhibits thereto) upon written request to the company's Investor Relations Department at: www.ittesi.com or ITT Educational Services, Inc. 5975 Castle Creek Parkway, North Drive, Indianapolis, Indiana 46250.

The Annual Meeting of Shareholders

will be held at 10:30 a.m., local time, on Tuesday, May 11, 1999, at the Sheraton Premiere Hotel at Tysons Corner, 8661 Leesburg Pike, Vienna, Virginia 22182.

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HIGHLIGHTS

Data in thousands, except per share, technical institutes, student and employee data.

	1998	1997
Revenues	\$291,375	\$261,664
Net Income	\$23,157*	\$19,123
Earnings Per Share: Basic	\$0.86*	\$0.71
Earnings Per Share: Diluted	\$0.85*	\$0.71
Average Outstanding Shares	27,002	27,000
Shareholders' Equity at Year End	\$101,856	\$87,815
Per Common Share	\$3.77	\$3.25
Capital Expenditures, Net	\$11,381	\$11,465
Number of ITT Technical Institutes at Year End	65	62
Student Enrollment at Year End	25,608	24,498
Number of Employees	3,120	2,750

*Excludes \$9,216 (after tax) of one-time expenses, or \$0.34 per share.

ABOUT THE COMPANY

The company: ITT Educational Services, Inc. (“ESI”) is a leading provider of technology-oriented postsecondary degree programs. At the end of 1998, ESI operated 65 ITT Technical Institutes in 27 states, which predominantly provided career-focused degree programs of study in fields of technology to approximately 25,000 students. Two institutes initiated classes in January 1999. Headquartered in Indianapolis, Indiana, ESI has been actively involved in the higher education community in the United States since 1969. Shares are traded on the New York Stock Exchange under the symbol “ESI.” ESI has graduated more than 65,000 students in the 1990s.

The campuses: All ITT Technical Institutes are authorized by the state in which each is located and are nationally accredited or seeking accreditation by an accrediting commission recognized by the U.S. Department of Education.

The curricula: Curriculum offerings, leading primarily to associate’s and bachelor’s degrees, are designed to help students begin to prepare for career opportunities in various fields involving technology, such as electronics, computer-aided drafting, industrial design, automated manufacturing, computer visualization, telecommunications, computer network systems technology and chemical technology. ITT Technical Institute programs of study blend traditional academic content with applied learning concepts. Advisory committees, comprised of representatives of local businesses and employers, help each ITT Technical Institute periodically assess and update curricula, equipment and laboratory design.

The students’ schedules: Students attend classes year-round with convenient breaks provided throughout the year. Year-round classes enable students to complete bachelor’s degree programs and begin to pursue their careers in as few as three years. Bachelor’s degree programs are offered only at selected campuses. Classes in most programs are typically offered in four-hour sessions five days a week and are generally available in the morning, afternoon and evening, depending on student enrollment. This class schedule provides students with flexibility to pursue part-time employment opportunities.

Market share: According to U.S. Department of Education data, ITT Technical Institutes granted the largest percentage (12.9 percent) of associate’s and bachelor’s degrees awarded in the U.S. in electronics and electronics-related programs in the 1996-1997 school year, the latest year for which statistics are available. ITT Technical Institutes also awarded the largest share (20.5 percent) of associate’s and bachelor’s degrees awarded in the U.S. in drafting programs during the 1996-1997 school year.

Growth: ITT Technical Institutes are positioned to benefit from projected demographic, economic and competitive trends. These trends include:

- an increasing number of high school graduates in the U.S.
- an increasing number of adults seeking postsecondary education
- an increasing demand for technically-skilled workers
- an increasing demand for curricula focused on new technologies.

LETTER TO SHAREHOLDERS:

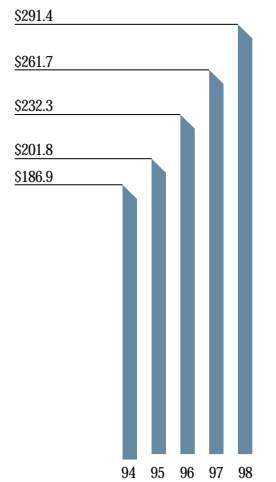
February 1, 1999 is “independence day” in the corporate history of ITT Educational Services, Inc. (“ESI”). ESI’s independence came on this date as a result of a successful underwritten public offering of 7.95 million shares of ESI common stock owned by ITT Corporation (“ITT”), a subsidiary of Starwood Hotels & Resorts Worldwide, Inc. (“Starwood”), and ESI’s repurchase of ITT’s remaining 1.5 million shares of ESI common stock. Starwood acquired ITT in February 1998. At the time of the acquisition, ITT owned 83.3% of ESI’s common stock. Starwood sold its entire stake in ESI through two separate public stock offerings (one involving 13.05 million shares on June 9, 1998, and the other involving 7.95 million shares on February 1, 1999) and a stock repurchase by ESI.

Now that ESI is a completely independent company, the ESI management team is poised to increase shareholder value as we strive to become the largest provider of technology degree programs in the U.S. As the nation prepares to build bridges to the next century, ESI is constructing its own bridges through the development of Information Technology (“IT”) degree programs that are tailored for today’s business environment. The introduction of these IT degree programs should provide ESI with opportunities for higher student enrollment growth over the next five years that can lead to increased revenue and profit.

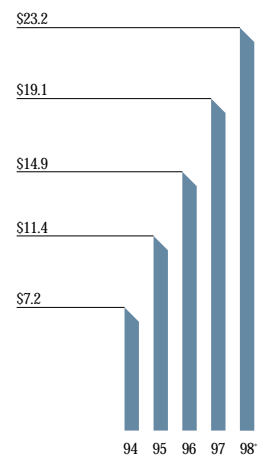
Preparing for our independence consumed significant portions of management time in 1998, as reflected by the following summary of key events. For additional information on these events, please refer to our 1998 Annual Report on Form 10-K and to the Management’s Discussion and Analysis of Financial Condition and Results of Operations section in this report.

- Starwood’s February 23, 1998 acquisition of ITT triggered a change in control of ESI under U.S. Department of Education (“DOE”) regulations, which caused all of ESI’s ITT Technical Institutes to lose their eligibility to participate in federal student financial aid programs. This loss of eligibility prevented our students from using federal financial aid to pay their education costs. As a result of our strong working relationship with the DOE, all of the ITT Technical Institutes regained their eligibility to participate in federal student financial aid programs within 25 days, averting a material adverse financial impact on the company. This change in control led to one-time expenses of \$0.5 million after tax, or \$0.02 per share, in the first six months of 1998, including costs associated with establishing new employee benefit plans.
- In June 1998, ESI incurred one-time expenses of \$1.0 million after tax, or \$0.04 per share, associated with the public offering of 13.05 million shares, at \$24.25 per share, of ESI common stock owned by ITT. This offering reduced ITT’s ownership interest in ESI from 83.3% to 35%.
- During the third quarter of 1998, we incurred one-time expenses of \$7.7 million after tax, or \$0.28 per share, associated with the settlement of student litigation and claims.

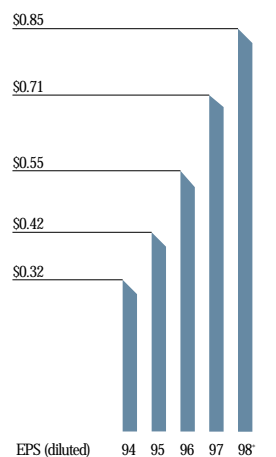
REVENUES
1994-1998 (\$ in Millions)



NET INCOME
1994-1998 (\$ in Millions)



EARNINGS PER SHARE



*Excludes \$9.216 (after tax) of one-time expenses, or \$0.34 per share.

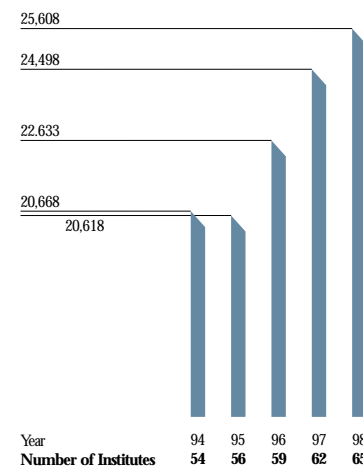


- In the fourth quarter of 1998, we filed a registration statement for another public offering of shares of ESI common stock owned by ITT. In February 1999, this offering was successfully concluded for 7.95 million shares, at \$34.00 per share, together with ESI's repurchase from ITT of an additional 1.5 million shares of ESI common stock.

EDUCATION MARKET

The pace of technological innovation continues unabated in the United States, as businesses jockey to increase productivity in order to remain competitive in the global marketplace. Products and services involving computers and electronics technology touch nearly every aspect of our daily lives. This technological revolution is accelerating as we approach the new millennium.

ITT TECHNICAL INSTITUTE
STUDENT CENSUS GROWTH



Companies are beginning to realize that the challenge (or perhaps the paradox) is finding knowledgeable workers with the technical skills necessary to utilize and implement technological innovations. The country is facing a large deficit in the number of workers with the required technical skills.

The employment sections of Sunday newspapers across the nation are filled with help-wanted ads for technologists. We consider this demand for technologists to be a window of opportunity for our schools, and it is the reason we have chosen to focus our energies on offering more technology degree programs at our ITT Technical Institutes. A number of independent studies confirm the work force shortages facing many of the technology sectors of our nation's economy. Electronics and information technology degree programs are high-growth, niche sectors within the postsecondary education industry, and there are high barriers for competitors contemplating entry into this market. Not only do potential competitors have to deal with the significant regulation in this area by the states, accrediting commissions and DOE, they also have to be able to accommodate the high capital costs for the necessary teaching equipment used in these types of programs.

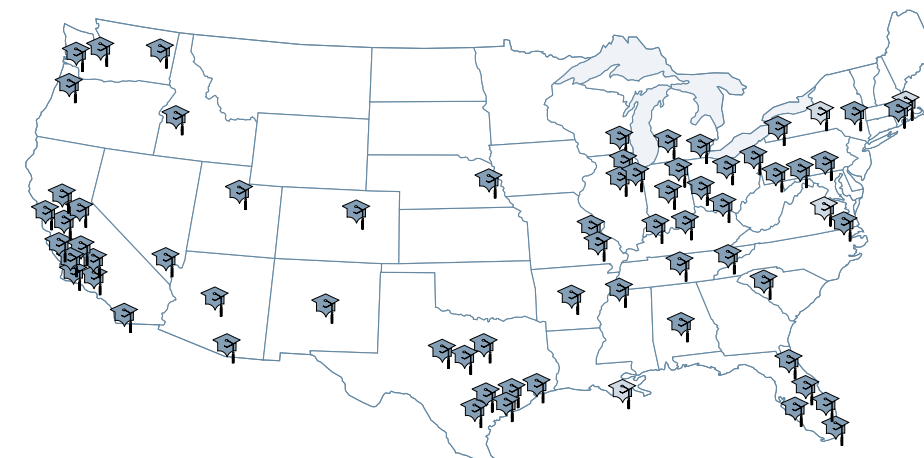
The Bureau of Labor Statistics ("BLS") reported in the September 1998 issue of its *Occupational Outlook Quarterly* that: "Opportunities abound in the field of information technology. The job market for computer-related occupations is booming, and demand for computer professionals is projected to remain strong through the year 2006. A degree in computer science or a related technical field is perhaps the easiest ticket into the field." The BLS projects that more than 1.0 million new jobs will be created in IT occupations between 1996 and 2006. The BLS further projects that, during this period, the number of jobs in all occupations in the country will grow 14 percent while the number of jobs in IT occupations will grow 108 percent.

Based on these reports, we researched and developed new degree programs in various fields of IT. It is our goal to become the market share leader in IT degree programs, just as we have become the market share leader in awarding associate's and bachelor's degrees in electronics and electronics-related programs and in drafting programs.


STRATEGY


Our strategy is to pursue multiple opportunities for growth. We are implementing a business plan designed to increase revenues and operating efficiencies by increasing the number of program offerings and student enrollment at existing institutes and by opening new institutes across the United States. The principal elements of this strategy include the following:

- During the second half of 1998, we launched a new associate's degree curriculum in Computer Network Systems Technology ("CNST") at three of our ITT Technical Institutes. As a result of this successful introduction, we have chosen to introduce this curriculum at an additional 27 ITT Technical Institutes in 1999.
- Although the introduction of the CNST program at 27 new sites will require approximately \$5.0 million of additional capital expenditures and will result in operating losses at these sites during the first 12 months following the initial introduction of the program, management has set an internal goal to increase earnings per share in 1999 by 20% over 1998.
- We currently plan to offer the CNST program at an additional 35 schools in 2000. Our total student enrollment could possibly increase by double digit percentages as a result of these CNST offerings and continued growth in new students attending our electronics and drafting programs.
- Our market research also indicates a need in the workplace for degreed technicians in other IT areas. As a result, we plan to introduce new associate's degree programs in Multimedia, Programming and Web Development at several schools in the second half of 1999.
- We also plan to continue opening new schools. In 1998, we opened a new school in each of the greater Chicago, Illinois; Dallas, Texas; and Albany, New York areas. Two additional new schools opened in January 1999 (one near Syracuse, New York and the other in Richmond, Virginia), a third is scheduled to open in April near New Orleans, Louisiana and a fourth is currently scheduled to commence classes in October near Boston, Massachusetts. By the end of 1999, we plan to have 69 schools located in 28 states. We believe that there are other attractive geographic locations for future ITT Technical Institutes and we intend to continue opening new schools.
- Our efforts to optimize school capacity and class size have helped us to increase student enrollment and, thereby, revenues without incurring a proportionate increase in fixed costs at our institutes. In addition, we have realized substantial operating efficiencies by centralizing management functions and implementing operational uniformity among our 67 institutes. As a result of these operating efficiencies, expenses incurred at our headquarters (including district offices) declined as a percentage of revenues from 6.6% in 1994 to 5.1% in 1998. We will continue to seek to improve margins by increasing enrollments and revenues without incurring a proportionate increase in fixed costs at our institutes.



At the end of 1998, ITT Educational Services, Inc. was providing technology-oriented higher education to more than 25,000 students in 27 states through its 65 ITT Technical Institutes.

 ITT Technical Institutes opened prior to 1999.

 ITT Technical Institutes that initiated or are scheduled to initiate classes in 1999.

FINANCIAL HIGHLIGHTS

One of the more gratifying events in 1998 was the unexpected honor bestowed upon ESI by *Forbes* magazine in being named to the *Forbes*' list of the "200 Best Small Companies in America."

Some of our key financial accomplishments in 1998 are listed below (the one-time expenses discussed above have been excluded from the 1998 data shown below):

- Revenues in 1998 rose to \$291.4 million, an 11.3% increase, from \$261.7 million in 1997.
- Operating Income in 1998 was \$33.4 million, a 27.5% increase from \$26.2 million in 1997.
- Net Income in 1998 was \$23.2 million, 21.5% greater than the \$19.1 million of net income in 1997.
- Our balance sheet at year-end 1998 was exceptionally strong, with \$119.3 million in cash, restricted cash and marketable debt securities even after internally funding growth projects, and we had no debt. We invested \$49.1 million to repurchase 1.5 million shares of ESI common stock from ITT. There are now approximately 25.5 million shares of ESI common stock outstanding.
- Earnings per share rose to \$0.85 per share, compared to \$0.71 per share in 1997. During 1998, we met or exceeded the consensus estimates of the stock analysts covering ESI in each of the four quarters. Since becoming a public company in December 1994, we have experienced 16 consecutive quarters of earnings performance at or above the consensus estimates of the analysts.
- ESI's share price on December 31, 1998 was \$34.00 per share, compared to \$22.31 per share on December 31, 1997, a 52.4% increase.

As we look ahead to the 21st century, the one thing certain to occur in the world is technological advancement at an accelerating pace. New opportunities in the competitive global economy will continue to be created for companies and individuals capable of harnessing the information and knowledge inherent in new technologies. The need for a work force with more and better technical skills will continue. Capitalizing on the burgeoning need for knowledgeable technical workers is our aim.

ITT Educational Services, Inc. is uniquely positioned to take advantage of these attractive market conditions. Few education systems in the United States have the broad geographic network of schools that ESI possesses. We believe that we are pursuing a plan that will allow us to offer the right products in the right geographic locations at the right time to help us become the market share leader in information technology degree programs. Our employees' dedication and commitment to offering a quality education has allowed ESI to grow and succeed.

Our confidence about the future is so strong that we literally put our money where our mouth is and invested nearly \$50 million to repurchase 1.5 million shares of ESI common stock. We are looking forward to the new millennium and the opportunity to become the largest provider of technology degree programs.



Rene R. Champagne
Chairman, President, and CEO

BUSINESS OVERVIEW

Technological revolution changes the way we do business

It has been said that technology drives the global economy, that it determines an organization's competitiveness and that businesses today cannot succeed without it. Technology is power, but only if you know how to use it.

Technology has transformed the world from a manufacturing, manual labor economy to an electronic, knowledge-based economy. Steel, coal and oil were the key resources of the industrial era. The resources of the new, information economy are knowledge and skills. The knowledge-based economy is dependent on the brainpower of its workers and their skills in effectively obtaining, processing and delivering information.

The new era requires new skills, making postsecondary education increasingly important. "We're standing at the edge of the next great economy," Vice President Al Gore said in January 1999. "Once it was land and capital, now it is knowledge... And the lack of training and skills is holding back our economy."

The information economy requires people with skills that enable them to use and advance the country's technology. According to the Bureau of Labor Statistics' *1998-99 Occupational Outlook Handbook*, "Employment of computing professionals is expected to increase much faster than average as technology becomes more sophisticated and organizations continue to adopt and integrate these technologies, making for plentiful job openings."

In July 1998, MIT economist Lestor Thurow wrote that "the skills of the work force are going to be the key competitive weapon in the 21st century. Brainpower will create new technologies, but skilled labor will be the arms and legs that allow one to employ the new product and process technologies that are being generated. Skilled people... become the only... sustainable competitive advantage."

Due to this transformation, the rules for business, education and society as a whole are changing. Success in today's economy depends on workers having skills and the ability to adapt to ever-changing technologies and work environments. If technology is the engine that will drive the Information Age, skilled employees are the fuel and education is the key that starts the engine.

THE HIGHER EDUCATION MARKET

Postsecondary education is expected to undergo demographic and market shifts

Education in the United States is a \$650 billion a year industry, making up about nine percent of the U.S. gross domestic product. Education is second only to health care in terms of national expenditures.

More than \$210 billion is spent annually on postsecondary education in this country, according to the U.S. Department of Education. Currently, only about \$4 billion is spent annually on proprietary postsecondary institutions. "Many investors are just starting to think of this as an industry," said William Weld, former governor of Massachusetts. "But there are a ton of demographic trends that are going to make the for-profit segment grow astronomically."

Electronics
Engineering
Technology



*Associate's and
Bachelor's degree*

In the associate's degree program, students begin to develop the knowledge and skills for entry-level positions in fields involving electronics, including aviation, communications, computers and defense. In the bachelor's degree program, students build on the earlier coursework to develop a more advanced foundation, with subjects such as process control, advanced communication systems, circuit design and calculus.

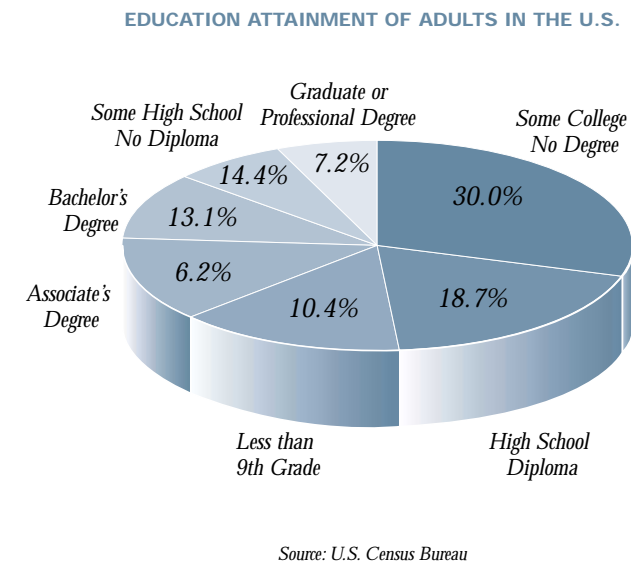


Associate's degree
Computer-aided
drafters use computers
to translate ideas, sketches
and specifications of an
engineer, architect or
designer into complete
and accurate working
plans. In ITT Technical
Institutes' Computer-
Aided Drafting
Technology programs,
as well as the schools'
Architectural Engineering
Technology and Tool
Engineering Technology
programs, students
begin to develop the
knowledge and skills
for various entry-level
positions in fields using
computer-aided drafting.

Several economic and demographic trends are occurring simultaneously that could help expand opportunities for proprietary providers of postsecondary education:

- Projected increases in the number of high school graduates
- An increasing value of postsecondary education
- An increasing number of adults returning to improve their skills
- The rising demand for technically-skilled workers
- Decreased funding for publicly-subsidized higher education institutions

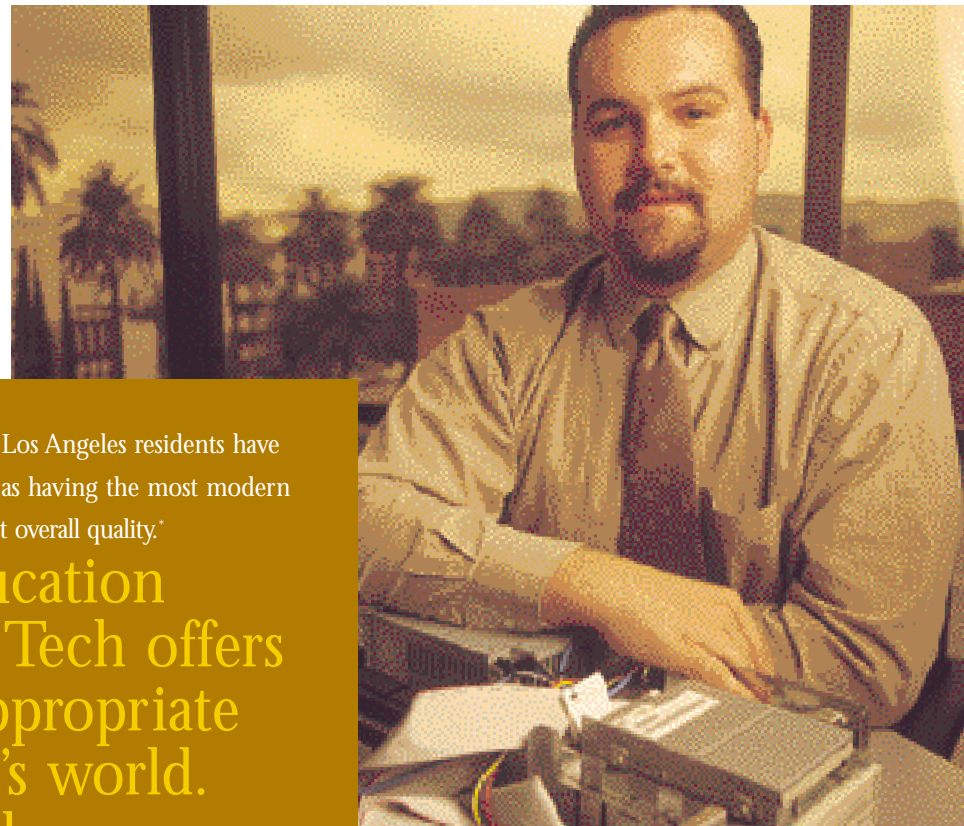
The industry's shortage of skilled workers has raised the priority of postsecondary education on the national agenda. Educational institutions that have effective solutions to this problem should prosper. ESI is positioned to increase shareholder value by capitalizing on the trends affecting education.



FORMULA FOR SUCCESS

ESI couples company attributes with powerful economic trends, including:

- A proven business model — ESI offers a quality education through a national education system with significant customer support services.
- One of the main advantages an established provider such as ESI enjoys is the ability to distribute new programs of study through its national network of institutes. ESI is able to pilot a new curriculum at one institute and, if proven successful, roll it out to other ITT Technical Institutes across the country.

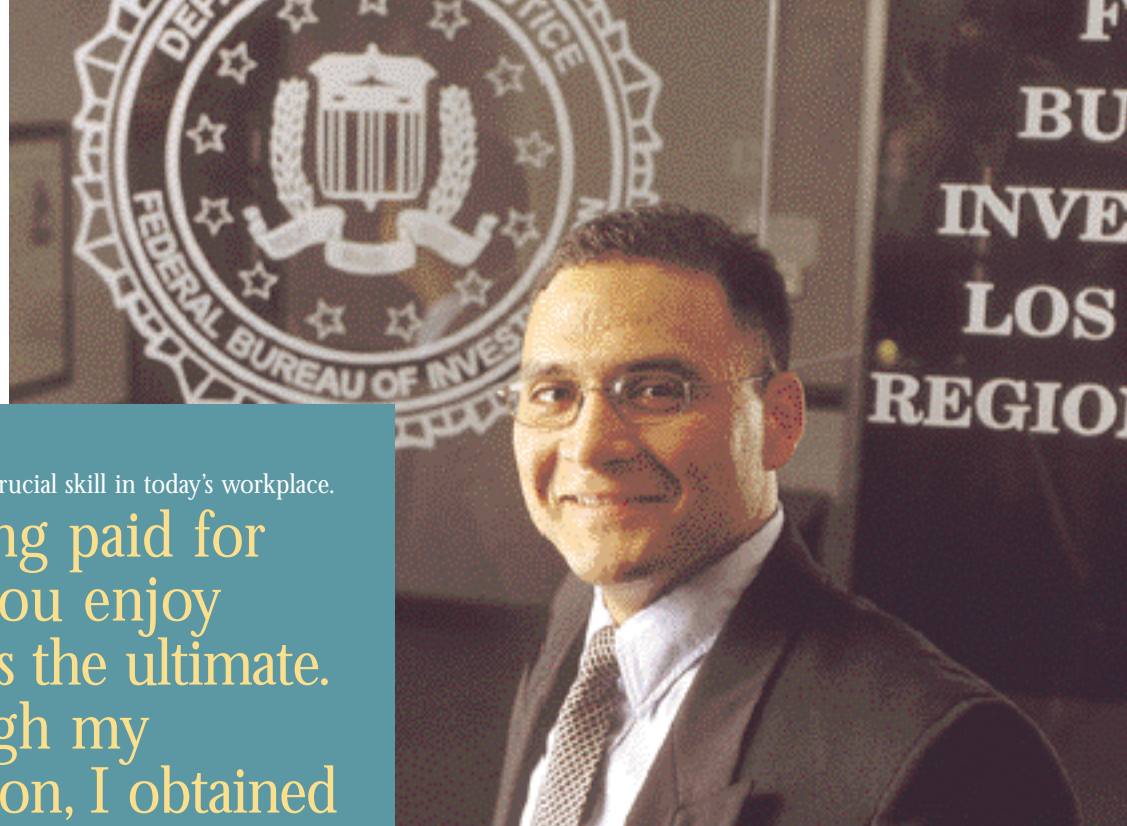


Keith Usery, graduate
Associate's degree, Electronics Engineering Technology
West Covina, California 1998
Biomedical Technician
Cedars-Sinai Medical Center

Three times in a row, Los Angeles residents have selected Cedars-Sinai as having the most modern equipment and the best overall quality.*

“The education that ITT Tech offers is very appropriate for today’s world. The hands-on experiences that are a part of the program made the difference.” Technicians, like ITT Tech alumnus Keith Usery, help maintain that reputation of excellence.

*Source: Cedars-Sinai web site
(<http://www.csmc.edu/mktg/Cedars-Sinai/CSHS/brochure.html>)



Teamwork is a crucial skill in today's workplace.

“Getting paid for what you enjoy doing is the ultimate. Through my education, I obtained the technical basics that I needed to succeed. ITT Tech helped prepare me in every way.”

Luckily, Bernard Zavala investigated a school that incorporates teamwork into the learning process.

Bernard Zavala, graduate

Bachelor's degree, Automated Manufacturing Technology

West Covina, California 1998

Electronics Technician

Federal Bureau of Investigation

- **Increased market demand** — According to the U.S. Bureau of Labor Statistics, technology-related positions represent the top three occupations expected to have the fastest employment growth between 1996 and 2006.

- **Increasing target audience** — In addition to the projected need for skilled workers, ESI may also benefit from the increasing number of potential students.

The number of high school graduates, referred to as the “echo boomers,” is expected to increase from 2.5 million in 1995 to 3.1 million in 2008. Additionally, more of these high school graduates are pursuing postsecondary education. The percentage of high school graduates enrolling in some form of postsecondary education increased from 49 percent in 1980 to 65 percent in 1996.

Another growing audience for postsecondary education is the “non-traditional” student, age 25 or older. Many of these individuals are going back to school because they’ve been downsized out of jobs in a turbulent economy or because their careers require that they update their skills. Together, the echo boomers and the adult students are placing an unprecedented strain on institutions of higher education, and a number of these people will turn to institutions such as ITT Technical Institutes.

- **Limited competition** — The need for technically-skilled workers has been well-publicized. Furnishing our institutes with the type of equipment similar to what is used in industry requires a significant financial investment. This capital investment discourages many school systems and other companies from offering technology programs of study.

Automated
Manufacturing
Technology



Bachelor's degree

As the workplace

becomes increasingly

automated, there's a

need for technicians

who understand

automated technology.

In ITT Technical

Institutes' Automated

Manufacturing Technology

program, the coursework

is intended to build upon

the electronics, science

and mathematics course-

work the student has

completed in previous

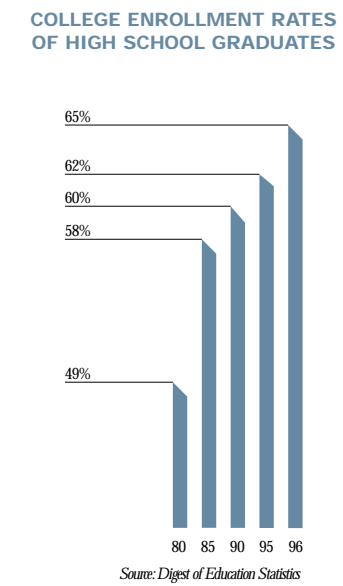
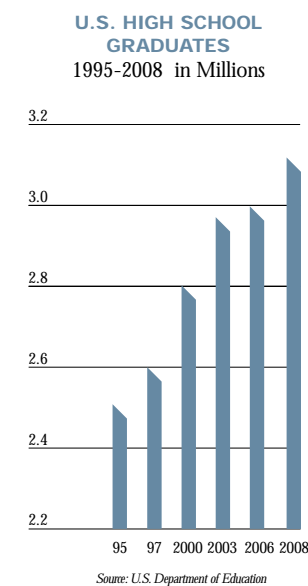
undergraduate work,

with subjects that include

digital electronics,

hydraulics/pneumatics

and robotic systems.



Associate's degree

Computer networks are an integral part of the business environment. As a result, ITT Technical Institutes help students explore a wide variety of networks through classroom and laboratory experiences, along with such topics as global system integration, network system design and implementation of network systems.

- **Barriers to entry** — Institutions of higher education must be authorized by state education authorities and accredited in order to participate in federal student financial aid programs. Obtaining state authorization and accreditation are very complex and time-consuming processes.
- **Brand name** — ESI enjoys brand recognition. In its 30-year history, ESI has been able to develop credibility through the brand name of ITT Technical Institute.
- **Multiple opportunities for growth** — ESI's strategy for growth includes developing new programs of study, broadening the availability of existing program offerings at additional ITT Technical Institutes and establishing new institutes.

In 1998, ESI opened three new institutes, one each in Burr Ridge, Illinois; Richardson, Texas; and Albany, New York. During the year, we increased the number of program offerings at 12 existing institutes and launched the associate's degree program in Computer Network Systems Technology (see page 21).

These combined forces provide ESI with significant competitive advantages.

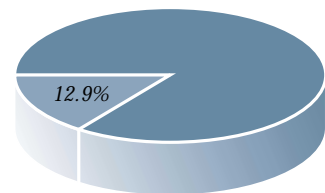
MARKET SHARE

The postsecondary education industry is highly fragmented, with no one college or system of colleges enjoying a significant market share.

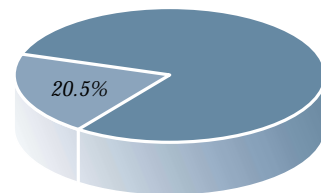
However, ESI is the market share leader in awarding degrees in electronics and electronics-related programs of study and in drafting programs of study. According to U.S. Department of Education data, ITT Technical Institutes awarded the largest percentage (12.9 percent) of degrees granted in the U.S. in electronics and electronics-related programs in the 1996-1997 school year, the latest year for which statistics are available. ITT Technical Institutes also granted the largest share (20.5 percent) of all degrees awarded in the U.S. in drafting programs in the 1996-1997 school year.

MARKET SHARE PERCENTAGE OF ASSOCIATE'S AND BACHELOR'S DEGREES AWARDED

Percentage of electronics and electronics-related associate's and bachelor's degrees granted by ITT Technical Institutes among all U.S. postsecondary institutions



Percentage of drafting associate's and bachelor's degrees granted by ITT Technical Institutes among all U.S. postsecondary institutions



Source: U.S. Department of Education



When the computer system failed at a long-term hospice care facility, a state of emergency was created, since without the system no medications could be dispensed. Luckily, one of the pharmacy workers was also a student at ITT Tech.

“I was in the workplace for over 30 years when I decided to go back to school at ITT Tech to keep up with the constantly changing areas of technology.”

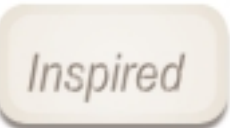
Within minutes, Ruth Davis had the system operational again, dispensing medication to the 480 patients.

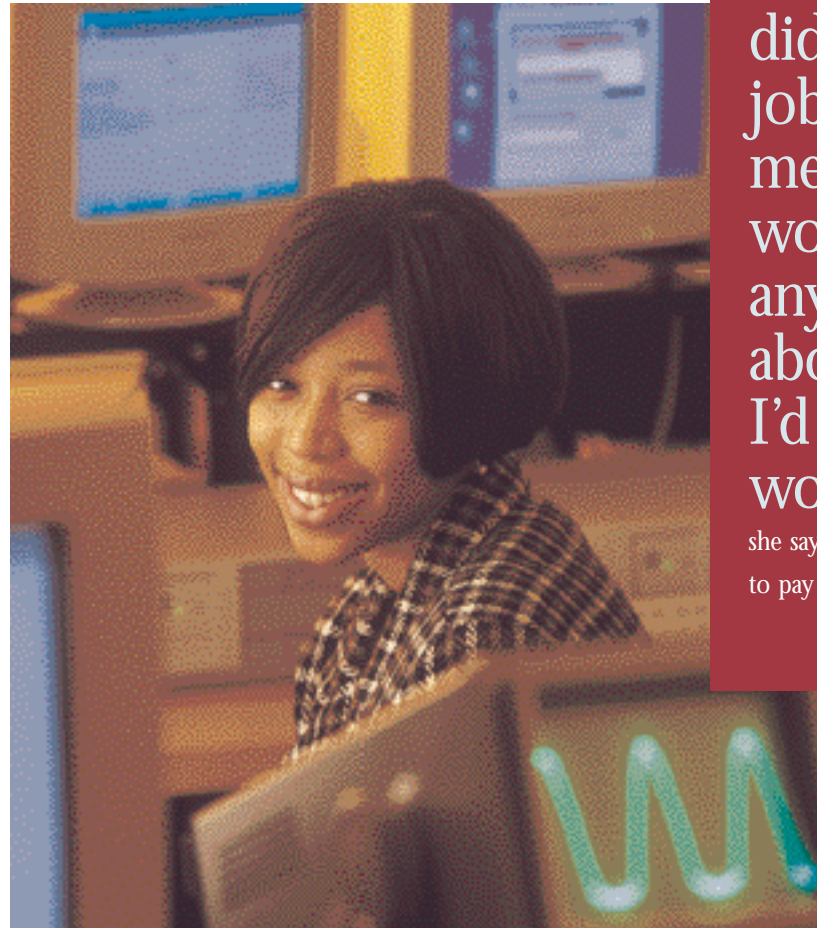
Ruth Davis, graduate

Associate's degree, Electronics Engineering Technology

Mechanicsburg, PA 1999

Genesis Health Ventures





Earning a degree in a technical field was a challenge for Josette Darvy. “Before I enrolled, I could easily see that careers related to technology were the future. The instructors did a fantastic job in preparing me for the workplace. To anyone thinking about ITT Tech, I’d say it is well worth it.” Despite the challenge, she says the hours of study are beginning to pay off in a challenging position.

Josette Darvy, graduate

Associate’s degree, Electronics Engineering Technology

Monroeville, Pennsylvania 1998

Communications Equipment Installer

Lucent Technologies

Hired

SKILLS GAP

“America’s new deficit,” a term coined by the Department of Commerce, doesn’t refer to dollars. It refers to the difference between the demand for and supply of technically skilled employees. Simply put, there isn’t enough qualified technical staff to fill all the open jobs.

The U.S. Department of Labor predicts the U.S. economy will annually produce more than 130,000 new information technology jobs between 1996 and 2006. Yet, the number of bachelor’s degrees awarded in computer science has been shrinking, at a rate of 42 percent between 1986 and 1995.

According to the February 23, 1998 issue of *Forbes*, the Hudson Institute estimates that the shortage of skilled workers in the U.S. economy will shrink the growth rate of the gross domestic product by five percent over the next five years. That translates into approximately \$200 billion in lost output, nearly \$1,000 for every American.

“Think about running out of iron ore in the midst of the industrial revolution and the impact on the world that would have had,” said Harris N. Miller, president of the Information Technology Association of America. “In the knowledge revolution, skilled people are our basic raw material. A skilled worker shortage is as much of a crisis as running out of iron ore would have been.”

This “skills anemia” is a result of the technological success of today’s economy. According to the January 19, 1998 edition of *Computer Reseller News*, “we have the ability to release new technology faster than we can build the skilled work force to implement and maintain the new products.”

Technology is changing so quickly that business and education must be willing to change quickly too. The technical skills gap creates an enormous business opportunity for educational institutions focused on fields of technology, such as our institutes.

LIFETIME LEARNING, CRADLE THROUGH CAREER

Need for skills, not just degrees

It’s safe to say that the days when having a bachelor’s degree would ensure lifetime career success are over. An average person can expect to change jobs nine times in his or her working life, so many people who thought their education ended with a bachelor’s degree are returning to the classroom to update or learn new career skills. Many of these adults are returning to classrooms outside of traditional colleges.

Employees and employers are beginning to embrace the “K-through-80” system of lifelong learning, meaning kindergarten through life. The need to return to school to keep their jobs or stay ahead of the competition has become a reality for many Americans.

Author Alvin Toffler said, “The illiterate of the 21st century will not be those who cannot read and write, but those who cannot learn, unlearn and relearn.”

Computer
Visualization
Technology



Bachelor’s degree
Computers have become one of the world’s most essential graphics tools. This program offers students a combination of theory and practical application in a variety of areas that use computer graphics technology, including prepress computing, computer modeling, 3D animation, and multimedia.



Bachelor's degree

This program helps graduates prepare for entry-level positions in many fields using telecommunications technology, such as telephone voice communications, data communications, computer networks, satellite systems, mobile communications, cellular and PCS systems and fiber optics.

Statistics show how employees with additional skills obtained through continued education can benefit employers. "Increasing the education level of our workers by one year raises the manufacturing productivity by 8.5 percent," said Jerry Jasinowski, president of the National Association of Manufacturers, in January 1999.

However, for employers and employees alike to enjoy the benefits of education, it is imperative that individuals obtain the skills needed in business and industry and not just earn degrees. Programs of study must be based on the skills that are in demand in the workplace.

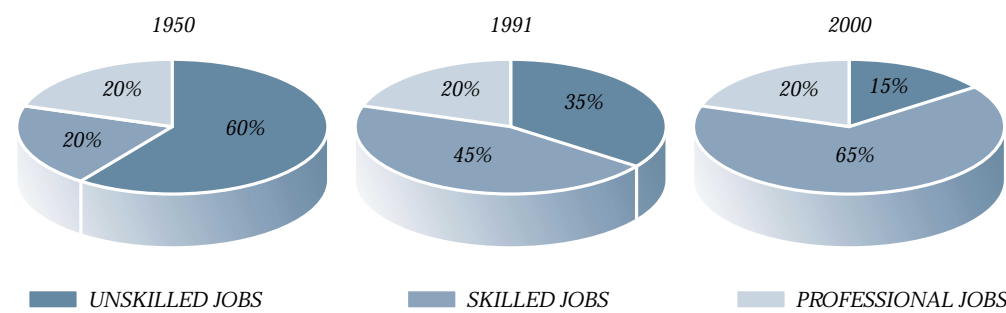
According to the U.S. Bureau of Labor Statistics, in 1950, unskilled jobs constituted 60 percent of all jobs, while skilled and professional jobs each represented 20 percent. By 1991, the percentage of unskilled jobs had declined to 35 percent, while skilled jobs had risen to 45 percent. Professional jobs remained at 20 percent. By the year 2000, 65 percent of the jobs in the work force are expected to require skilled workers, while only 15 percent are expected to require unskilled workers and 20 percent are expected to require professional workers.

Two trends are significant here: the demand for jobs requiring skilled labor has skyrocketed since 1950, while the percentage of jobs considered "professional" has remained constant at only 20 percent.

Speaking at a conference to address the technical skills gap, Senator Bob Kerrey of Nebraska said that marketable job skills are the most important outcome of any level of postsecondary education. "If you can't graduate and get a job, it's all garbage as far as I'm concerned," he said. "You need much more than a store of knowledge to walk in the workplace and have it think you're worth something."

Employers now want lifetime learning for their employees, with continuous "up-skilling" in technological innovations. However, classroom time competes with time at work, time with family and time for leisure for these employees. Institutions that can help meet the postsecondary education requirements of employers and employees in a convenient fashion will benefit from this need for lifetime learning.

CHANGING U.S. WORK FORCE

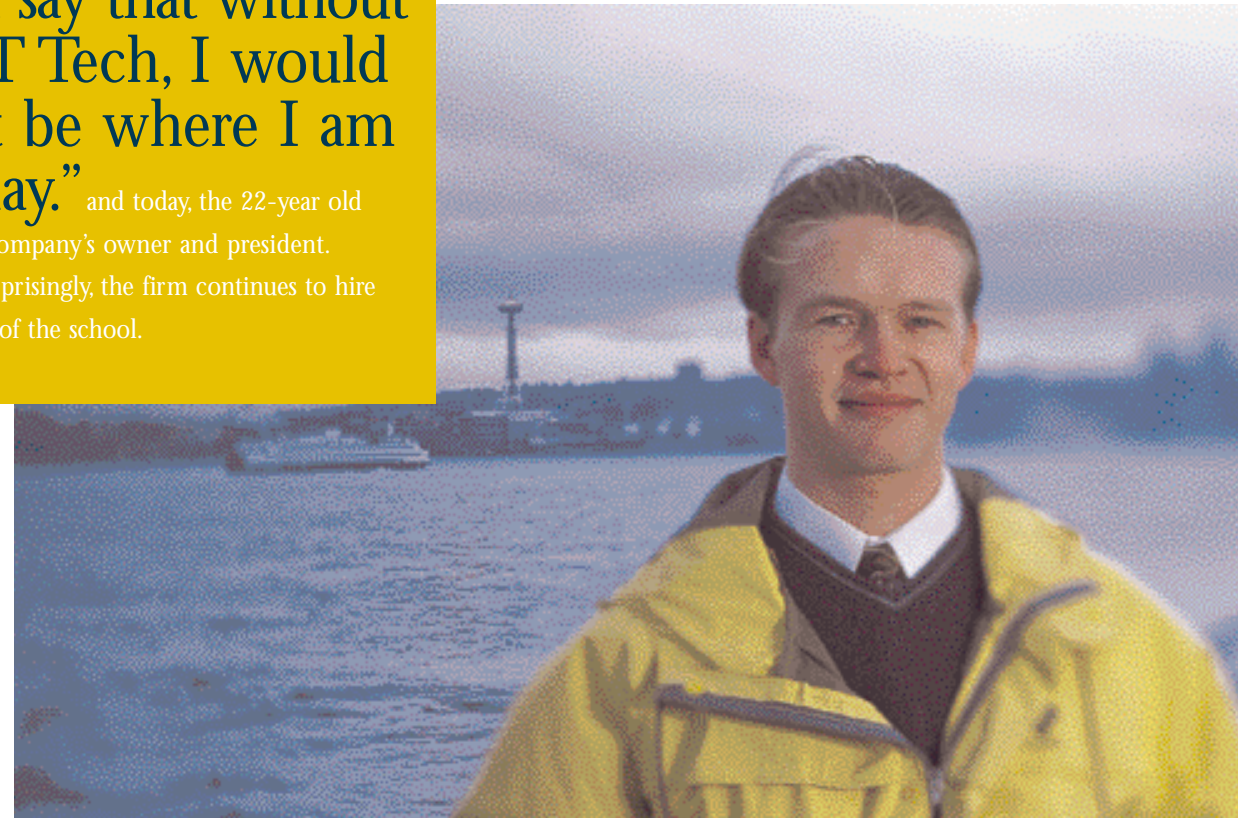


Source: U.S. Bureau of Labor Statistics

Shortly after being hired by The CADD Group Inc., a drafting firm that continually works in conjunction with the architectural firm that did renovations on the Space Needle, ITT Tech graduate Ryan J. Seyfert took advantage of an opportunity

"I am very satisfied with the education that I received and can say that without ITT Tech, I would not be where I am today."

and today, the 22-year old is the company's owner and president. Not surprisingly, the firm continues to hire alumni of the school.



Ryan J. Seyfert, graduate

Associate's degree, Computer-Aided Drafting Technology

Seattle, Washington 1998

President

The CADD Group

From student to teacher. From teacher to mentor. And from mentor to co-worker.

“ITT Tech has been such a big part of my success that I wanted to give something back,” Jim said.

“That’s one of the reasons I teach.” That’s the path that brought Jim Geymont and Andy Mendez together at the same school and, eventually, the same company.

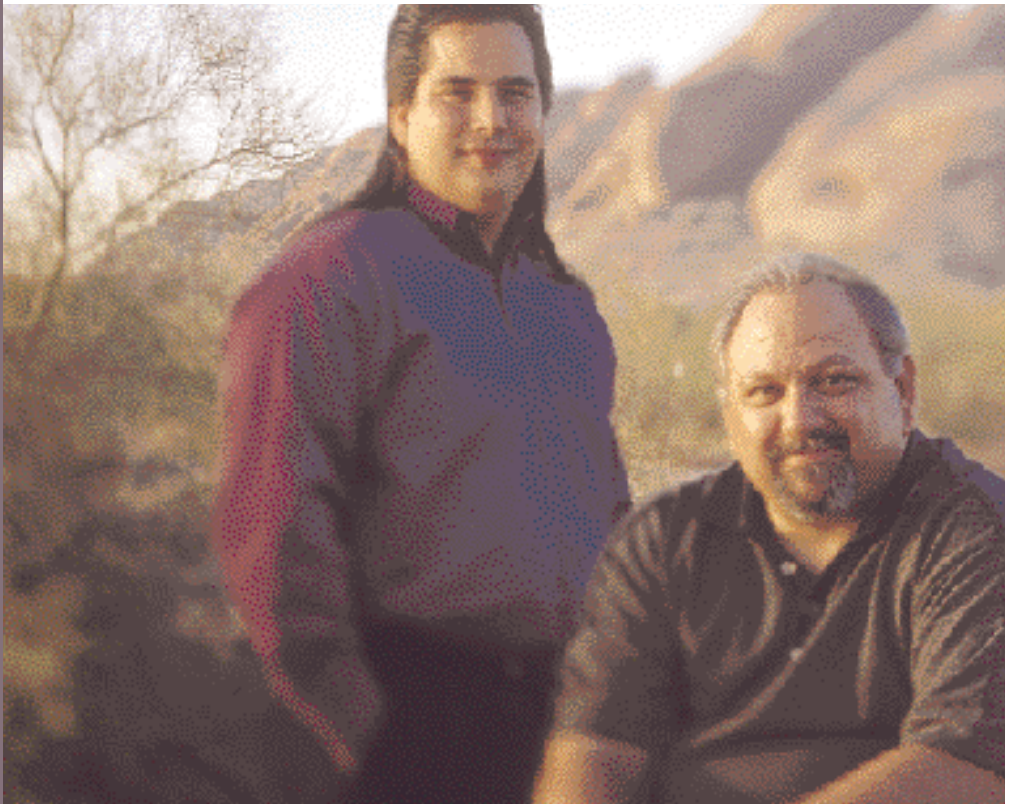
Andy Mendez, graduate

Associate's degree, Computer-Aided Drafting Technology

Phoenix, Arizona 1997

Assistant CAD Programmer

OSP Consultants



Jim Geymont, graduate and ITT Technical Institute instructor

Bachelor's degree, Electronics Engineering Technology

Phoenix, Arizona 1998

Engineering CAD Manager

OSP Consultants



AN EDUCATION THAT IS CUSTOMER-DRIVEN, MARKET RESPONSIVE

ITT Technical Institutes offer quality education to help meet employers' and students' needs

An ITT Technical Institute education is designed to help promote lifetime learning. The programs of study deliver a skills-based education that is sensitive to market needs and are offered at times that students can go to school.

Shifting from a manufacturing economy to an information economy requires educational institutions to adapt and evolve accordingly. The economic future of this country depends on a work force with different skills than those of past generations.

On this topic, author Charles Handy wrote in the September 1, 1998 edition of *Change* magazine, “The danger is that our traditional schools and colleges will lag behind, designed by people from a world that used to be, for a world that will be no more, rather like our armies, which were always well trained for the last war. If we fail, this time, to leap beyond our own experience, we will fail our youth. It is indeed a time for bold imaginings, for reinventing what we understand by education.”

As a customer-driven organization, ESI has developed a system of education that strives to meet the needs of its two key customers: students and employers.

Students want more convenient educational offerings, which ITT Technical Institutes are trying to provide. ITT Technical Institute students attend classes year-round with convenient breaks provided throughout the year. Year-round classes enable students to complete bachelor's degree programs and begin to pursue their careers in as few as three years. In addition, operating on a 12-month basis (rather than a nine-month basis) is a more efficient use of the company's facilities.

Classes in most programs at ITT Technical Institutes are typically offered in four-hour sessions five days a week. Depending on student enrollment, classes are generally available in the morning, afternoon and evening. This class schedule generally provides students with the flexibility to pursue part-time employment opportunities and accommodate other demands while in school.

ITT Technical Institute programs of study blend traditional academic content with applied learning concepts. Students also have the opportunity to learn from one another by working in teams for a beneficial exchange of information and ideas.

Each ITT Technical Institute devotes staff resources to assist and advise students regarding academic and financial matters. Assistance and advice are also offered to students looking for carpooling, housing and part-time employment.

Our corporate customers want graduates who possess relevant skills. ESI designs its curricula to help graduates begin to prepare for careers in various fields involving technology. Each ESI curriculum is regularly reviewed to respond to changes in technology and industry needs.

Project Management



Master's degree

This is a program designed to help students develop better critical thinking, communication and teamwork skills while reinforcing both the theoretical and applied principles of project management. The learning environment attempts to serve the needs of working adults who have multiple pressures and priorities, including full-time employment.



Associate's degree

In ITT Technical Institutes' chemical technology program, students have the opportunity to use diagnostic tools that are similar to the ones used in the workplace. Plus, through a combination of classroom theory and practical hands-on activities, students do analysis and testing and record data in classes such as applied organic and biochemistry laboratory.

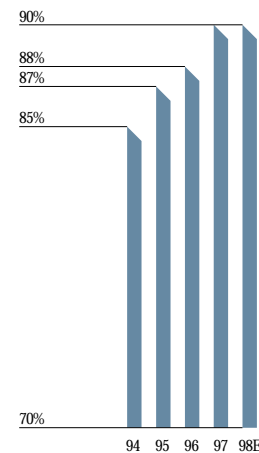
Each ITT Technical Institute has an advisory committee for each field of study which is comprised of representatives of local businesses and employers. These advisory committees assist the institutes in assessing and updating curricula, equipment and laboratory design.

In 1998, Federal Reserve Board Chairman Alan Greenspan said, "Building bridges between our educational institutions and the private sector should have payoffs in how well graduates are prepared to meet the challenges of an increasingly knowledge-based global economy."

ITT Technical Institutes strive to do this in the design of their curricula. According to the Hudson Institute's *Workforce 2020*, "Traditional colleges are largely inflexible in responding to labor market demands because of funding mechanisms and tenure systems. This lack of responsiveness to market conditions could account for the growth in enrollment in proprietary postsecondary schools such as ITT..."

We have listened to our students and corporate customers and we've designed programs to be flexible, easily accessible and responsive to the business needs of employers and the personal and career needs of today's students.

IMPROVED STUDENT OUTCOMES



Percentage of employable graduates* who obtained employment or were already employed in fields involving their programs of study.

* Employable graduates exclude graduates who continue in a bachelor's degree program at one of our institutes.



Bachelor's degree

Graduates of this program often aim toward a career involving industrial design in any number of manufacturing and service industries. The program is designed to teach students to combine graphics skills with artistic talent and problem solving in order to create functional and aesthetically attractive product designs.

IT WORKERS NEEDED

The demand for IT workers far outstrips the supply

One of the ways in which ESI is responding to the market is by creating Information Technology (IT) programs of study.

According to a September 1998 report by the U.S. Department of Labor, IT is projected to be the fastest growing industry between 1996 and 2006.

Workforce 1998, a study by the Information Technology Association of America (ITAA) and Virginia Polytechnic Institute and State University, indicates that IT worker shortages are large and growing. The study found that 346,000 IT positions were vacant in the three core IT occupational clusters of programmers, systems analysts and computer engineers.

Additionally, the Bureau of Labor Statistics projects that, between 1994 and 2005, the United States will require more than one million new IT workers in these three occupations alone.

One industry representative was quoted in the July 1998 issue of *HR Magazine*, "Any solution you provide to their [IT] staffing needs is like bringing a bucket of ice cubes into hell. The demands are just so great."

It's not just IT companies that are looking for IT workers. Businesses that are not considered part of the IT industry, such as banks, insurance companies and even small retail stores, now require employees who have the technical skills necessary to operate in the digital economy.

"IT worker shortages continue to be a national crisis today and into the foreseeable future. To solve this dilemma requires the collective wisdom and innovative actions of employers, educators and the government," said Harris Miller, president of ITAA, in 1998.

The work force projections for IT have been compared to a similar industry prediction from a classic movie. "College diploma fresh in hand, but clueless on how to spend the rest of his life ... , Dustin Hoffman was offered a word of advice in the 1967 movie classic *The Graduate*," the July 1998 *Georgia Trend* article reads. " 'Plastics,' his father's friend confided. Were *The Graduate II* to be made today, the older man would sidle up to Hoffman and say, 'Information Technology.' "

In an attempt to capitalize on the well-publicized skill shortage of information technology workers, ESI has developed four curricula involving IT. The first program, Computer Network Systems Technology (CNST), was launched at three ITT Technical Institutes in 1998. Twenty-seven more institutes are expected to begin offering this program in 1999. In addition, programs leading to degrees in Programming, Web Development and Multimedia are expected to be offered in 1999 at selected ITT Technical Institutes.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

The following discussion should be read with the Selected Financial and Operating Data and the Financial Statements and Notes to the Financial Statements included elsewhere in this annual report.

General

We operate 67 institutes in 27 states which provide technology-oriented postsecondary education to approximately 25,000 students. We derive our revenue almost entirely from tuition, textbook sales, fees and charges paid by, or on behalf of, our students. Most students at our institutes pay a substantial portion of their tuition and other education-related expenses with funds received under various government-sponsored student financial aid programs, especially the federal student financial aid programs under Title IV ("Title IV Programs") of the Higher Education Act of 1965, as amended (the "HEA"). In 1998, we indirectly derived approximately 69% of our revenues from Title IV Programs.

Our revenue varies based on the aggregate student population, which is influenced by the following factors:

- the number of students attending our institutes at the beginning of a fiscal period;
- the number of new first-time students entering and former students re-entering our institutes during a fiscal period;
- student retention rates; and
- general economic conditions.

New students generally enter our institutes at the beginning of an academic quarter that begins in March, June, September or December. We believe that, in the absence of countervailing factors, student enrollments and retention rates tend to increase as opportunities for immediate employment for high school graduates decline and decrease as such opportunities increase. Our establishment of new institutes and the introduction of additional program offerings at our existing institutes have been significant factors in increasing the aggregate student population in recent years.

A new institute must be authorized by the state in which it will operate, accredited by an accrediting commission that the U.S. Department of Education ("DOE") recognizes, and certified by the DOE to participate in Title IV Programs. The approval processes for accreditation and DOE certification cannot commence until the first students begin classes. Accreditation and DOE certification for a new location generally take approximately one year from the first class start date. We defer certain direct costs incurred with respect to a new institute prior to the first class start ("institute start-up costs") and amortize them over the first year of operation after the first class start. From January 1, 1994 through December 31, 1998, we opened 17 new institutes (six of which started classes in 1996 or 1997 and three of which started classes in 1998). We opened two additional institutes in January 1999. New institutes historically incur a loss during the 24-month period after the first class start date. These losses during a fiscal year by institutes in their first two years of operation, together with the amortization of institute start-up costs, are referred to as "operating losses from new technical institutes." The operating losses from new technical institutes totaled \$5.3 million for the year ended December 31, 1998, \$3.2 million for the year ended December 31, 1997, and \$5.7 million for the year ended December 31, 1996.

We earn tuition revenue on a weekly basis, pro rata over the length of each of four 12-week academic quarters in each fiscal year. Federal and state regulations and accrediting commission standards generally require us to refund a portion of the tuition payments received from a student who withdraws from one of our institutes during an academic quarter. Our statement of income recognizes immediately the amount of tuition, if any, that we may retain after payment of any refund. Other educational revenue includes textbook sales and laboratory fees.

We incur expenses throughout a fiscal period in connection with the operation of our institutes. The cost of educational services includes faculty and administrative salaries, cost of books sold, occupancy costs, depreciation and amortization of equipment costs and leasehold improvements, and certain other administrative costs incurred by our institutes.

Student services and administrative expenses include direct marketing costs (which are marketing expenses directly related to new student recruitment), indirect marketing expenses, an allowance for doubtful accounts and administrative expenses incurred at corporate headquarters. Direct marketing costs include salaries and employee benefits for recruiting representatives and direct solicitation advertising expenses. We capitalize our direct marketing costs (excluding advertising expenses) using the successful efforts method and amortize them on an accelerated basis over the average course length of 24 months commencing on the class start date. We expense as incurred our marketing costs that do not relate to the direct solicitation of potential students.

Until February 5, 1998, we forwarded all our cash receipts to ITT Corporation ("ITT") for investment on a daily basis after, in the case of some receipts, the lapse of applicable regulatory restrictions. ITT generally funded our cash disbursements out of our cash balances that it held and invested for us. Net interest income represents principally interest paid or received from ITT and miscellaneous interest paid or received from other parties. Beginning in 1995, ITT paid us interest on the full amount of any net cash balances that it invested for us at an interest rate that was set for a six- or twelve-month period and was 30 basis points over the most recently published rate for six- or twelve-month treasury bills, as appropriate, and no longer assessed us interest charges except with respect to funds actually advanced to us in excess of cash invested with ITT. ITT performed a number of other services for us, including the administration of certain employee benefit plans, for which we paid it compensation. We have been performing all of these services since June 9, 1998. We have been performing our own cash management functions since February 5, 1998, and we no longer have any cash invested with ITT. We have included the invested funds in the captions "cash and cash equivalents" and "marketable debt securities" in the December 31, 1998 balance sheet. The marketable debt

securities have maturity dates in excess of 90 days at the time of purchase and we record them at their market value. We include debt securities with maturity dates less than 90 days at the time of purchase in cash and cash equivalents and record such securities at cost which approximates market value. We estimate that the market risk associated with our investments in cash equivalents and marketable debt securities can best be measured by a potential decrease in the fair value of these securities resulting from a hypothetical 10% increase in interest rates. If such a hypothetical increase in rates were to occur, the reduction in the market value of our portfolio of securities would not be material.

Variations in Quarterly Results of Operations

Our quarterly results of operations tend to fluctuate significantly within a fiscal year because of differences in the number of weeks of earned tuition revenue in each fiscal quarter and the timing of student matriculations. Our first and third fiscal quarters have 13 weeks of earned tuition revenue, while our second and fourth quarters have only 11 weeks of earned tuition revenue because of two-week student vacation breaks in June and December. In addition, revenues in our third and fourth fiscal quarters generally benefit from increased student matriculations. The number of new students entering our institutes tends to be substantially higher in June (29% of all new students in 1998) and September (37% of all new students in 1998) because of the significant number of recent high school graduates entering our institutes for the academic quarters beginning in those two months. The academic schedule generally does not affect our incurrence of costs, however, and costs do not fluctuate significantly on a quarterly basis.

The following table sets forth our revenues in each quarter during the three prior fiscal years.

QUARTERLY REVENUE

(Dollars in thousands)

Three Month Period Ended	1998		1997		1996	
	Amount	Percent	Amount	Percent	Amount	Percent
March 31	\$ 72,287	25%	\$ 64,476	25%	\$ 57,103	25%
June 30	65,077	22	58,412	22	51,568	22
September 30	81,700	28	73,060	28	65,113	28
December 31	72,311	25	65,716	25	58,535	25
Total for Year	<u>\$ 291,375</u>	<u>100%</u>	<u>\$ 261,664</u>	<u>100%</u>	<u>\$ 232,319</u>	<u>100%</u>

RESULTS OF OPERATIONS

The following table sets forth the percentage relationship of certain statement of income data to tuition and other educational revenues for the periods indicated.

Year Ended December 31,	1998	1997	1996
Tuition and other educational revenues	100.0%	100.0%	100.0%
Cost of educational services	60.6	62.3	62.5
Student services and administrative expenses	28.0	27.7	28.6
Legal settlement	4.4	-	-
June 1998 offering, change in control and other one-time expenses	0.6	-	-
Operating income	6.4	10.0	8.9
Interest income, net	1.8	2.1	1.7
Income before income taxes	<u>8.2%</u>	<u>12.1%</u>	<u>10.6%</u>

Year Ended December 31, 1998 Compared with Year Ended December 31, 1997

Revenues. Revenues increased \$29.7 million, or 11.3%, to \$291.4 million for the year ended December 31, 1998 from \$261.7 million for the year ended December 31, 1997 primarily due to:

- a 5% increase in tuition rates in each of September 1998 and 1997;
- an 8.2% increase in the total student enrollment at January 1, 1998 compared to January 1, 1997 (24,498 at January 1, 1998 compared to 22,633 at January 1, 1997); and
- a 6.1% increase in the number of first-time and re-entering students beginning classes at our institutes (24,521 in 1998 compared to 23,111 in 1997).

The total student enrollment on December 31, 1998 was 25,608, an increase of 4.5% from the 24,498 total student enrollment on December 31, 1997.

Cost of Educational Services. Cost of educational services increased \$13.4 million, or 8.2%, to \$176.5 million in 1998 from \$163.1 million in 1997. The principal causes of this increase include:

- the costs required to service the increased enrollment;
- normal inflationary cost increases for wages, rent and other costs of services; and
- increased costs at new institutes (one opened in June 1997, two in December 1997, one in March 1998, one in June 1998 and one in October 1998).

Cost of educational services as a percentage of revenues decreased to 60.6% in 1998 compared to 62.3% in 1997, because the greater revenues did not cause an increase in the fixed portion of our rent, administrative salaries and other costs included in cost of educational services. Cost of educational services includes a \$1.2 million provision in 1998 (compared to a \$3.2 million provision in 1997) for legal expenses associated with the legal actions involving the hospitality program. Excluding this provision, cost of educational services in 1998 would have been 60.2% of revenues, a 0.9% improvement from 1997.

Student Services and Administrative Expenses. Student services and administrative expenses increased \$9.1 million, or 12.6%, to \$81.5 million in 1998 from \$72.4 million in 1997. Student services and administrative expenses increased to 28.0% of revenues in 1998 compared to 27.7% in 1997 primarily because of increased media advertising (up 14.8%) and an increase in the provision for doubtful accounts. The increase in the provision for doubtful accounts resulted from a decrease in the amount of Title IV Program funds we received, which was caused by a change in the DOE regulations that became effective July 1, 1997. See “-Liquidity and Capital Resources.”

One-Time Expenses. We recorded a \$7.7 million after tax (\$0.28 per share) provision for the settlement of certain legal proceedings and claims in 1998. (See Note 10 of Notes to Financial Statements). In June 1998, we incurred total expenses for the June 1998 offering of \$1.0 million after tax (\$0.04 per share). In addition, we incurred expenses of \$0.5 million after tax (\$0.02 per share) in 1998 associated with our change in control and establishment of new employee benefit plans.

Operating Income. The following table sets forth our operating income (in thousands) for the year ended December 31, 1998 and 1997:

Year Ended December 31,	1998	1997
Operating income as reported	\$ 18,636	\$ 26,223
Legal settlement	12,858	-
June 1998 offering expenses	1,117	-
Change in control and other one-time expenses	755	-
Operating income before one-time expenses	<u>\$ 33,366</u>	<u>\$ 26,223</u>

Interest Income. Interest income decreased \$0.2 million in 1998 compared to 1997, which was primarily due to the lower interest rate earned on our cash investments and marketable debt securities (i.e., 5.5% in 1998 compared to 6.3% in 1997) partially offset by the earnings on our increased invested balances.

Income Taxes. Our combined effective federal and state income tax rate in 1997 was 39.8%. Our 1998 federal and state income tax rate will be 41.8%, because \$0.9 million of the June 1998 offering expenses are not tax deductible.

Net Income. The following table sets forth our net income (in thousands) for the year ended December 31, 1998 and 1997:

Year Ended December 31,	1998	1997
Net income	\$ 13,941	\$ 19,123
Legal settlement (after tax)	7,715	-
June 1998 offering expenses (after tax)	1,048	-
Change in control and other one-time expenses (after tax)	453	-
Net income before one-time expenses	<u>\$ 23,157</u>	<u>\$ 19,123</u>

Year Ended December 31, 1997 Compared with Year Ended December 31, 1996

Revenues. Revenues increased \$29.4 million, or 12.7%, to \$261.7 million for the year ended December 31, 1997 from \$232.3 million for the year ended December 31, 1996 primarily due to:

- a 9.8% increase in the total student enrollment at January 1, 1997 compared to January 1, 1996 (22,633 at January 1, 1997 compared to 20,618 at January 1, 1996);
- a 5% increase in tuition rates in each of September 1997 and 1996;
- a 2.3% increase in the number of new first-time students who began attending our institutes (19,911 in 1997 compared to 19,464 in 1996); and
- the opening of new institutes (two in March 1996, one in September 1996, one in June 1997 and two in December 1997).

Student retention rates did not change materially in the two years. Our three new institutes beginning classes in 1997 accounted for 140 new students.

Cost of Educational Services. Cost of educational services increased by \$17.9 million, or 12.3%, to \$163.1 million in 1997 from \$145.2 million in 1996 principally as a result of:

- increased costs related to the introduction of additional programs;
- an increase in salaries and occupancy costs at our institutes opened prior to 1995;
- costs at the two new institutes opened in 1995;
- costs at the three new institutes opened in 1996;
- costs at the three new institutes opened in 1997; and
- to a lesser extent, an increase in the cost of books sold arising from the increased student population.

Provisions for legal expenses increased by \$1.9 million to \$3.2 million in 1997 (\$1.7 million in the fourth quarter) from \$1.3 million in 1996 (\$1.0 million in the fourth quarter) as a result of the legal actions associated with the California and Florida hospitality programs. Cost of educational services decreased to 62.3% of revenues in 1997 compared to 62.5% in 1996, primarily because the greater revenues did not cause an increase in the fixed portion of rent, administrative salaries and other costs included in the cost of educational services. Excluding the provisions for legal expenses, cost of educational services decreased to 61.1% of revenues in 1997 compared to 61.9% in 1996.

Student Services and Administrative Expenses. Student services and administrative expenses increased by \$5.9 million, or 8.9%, to \$72.4 million in 1997 from \$66.5 million in 1996 principally as a result of a \$5.0 million increase in marketing costs. This increase in marketing costs was due to:

- an increase in the marketing costs for the two new institutes opened in 1995 and the three new institutes opened in 1996;
- the commencement of marketing costs for the three new institutes opened in 1997; and
- the increased marketing costs for our institutes opened prior to 1995.

Our media advertising expenses increased by 10.9% in 1997 from 1996. Administrative expenses at the corporate headquarters increased by \$0.3 million in 1997 from 1996 levels primarily due to increased headquarters staff. The provision for doubtful accounts in 1997 was approximately \$0.6 million more than in 1996 principally because of increased revenues and a regulatory change that delays our receipt of funds under the Title IV Programs. The delay resulted in a greater number of students who withdrew or whose enrollment was terminated by the institutes before they could secure federal student financial aid with which they could pay their obligations to us. See “-Liquidity and Capital Resources” for a further description of the regulatory changes affecting when we receive Title IV Program funds after June 30, 1997. Student services and administrative expenses decreased to 27.7% of revenues in 1997 compared to 28.6% in 1996, primarily because the greater revenues did not cause an increase in the fixed portion of the marketing and headquarters expenses.

Interest Income. Interest income increased by \$1.4 million in 1997 because of the increase in the interest rate earned on the cash we invested with ITT (i.e., 6.3% in 1997 compared to 5.5% in 1996) and the increase in the amount of cash we invested with ITT.

Net Income. Net income increased \$4.2 million, or 28.2%, to \$19.1 million for 1997 from \$14.9 million for 1996, principally due to the 27.4% increase in operating income (\$3.4 million after tax).

Liquidity and Capital Resources

In 1998, we indirectly derived approximately 69% of our revenues from Title IV Programs. Federal regulations dictate the timing of disbursements of funds under Title IV Programs. Students must apply for a new loan for each academic year, which consists of three academic quarters. Loan funds are generally provided by lenders in three disbursements for each academic year. The first disbursement is usually received either 30 days after (in the case of students commencing a program of study) or ten days before the start of the first academic quarter of a student's academic year, and the second and third disbursements are typically received ten days before the start of each subsequent quarter of a student's academic year. While the timing of loan disbursements to us is subject to a student's directions to the lender and to existing regulatory requirements regarding such disbursements, we have typically received student loan funds upon the lender's disbursement of the student loan funds.

DOE regulations that became effective July 1, 1997 revised the procedures governing how an institution participating in Title IV Programs requests, maintains, disburses and otherwise manages Title IV Program funds. The revised regulations require us to receive Title IV Program loan funds in three equal quarterly disbursements rather than the two disbursements previously permitted. We estimate that this change decreased deferred tuition revenue or increased accounts receivable by approximately \$15 million at December 31, 1997 compared to December 31, 1996. We also estimate this change (an ongoing effect) decreased 1997 interest income by \$0.2 million and decreased 1998 interest income by \$0.9 million.

Our principal uses of cash are to pay salaries, occupancy and equipment costs, recruiting and marketing expenses, administrative expenses and taxes, including institute start-up costs for new institutes. Until February 5, 1998, we forwarded our cash receipts to ITT on a daily basis after, in the case of certain receipts, the lapse of applicable regulatory restrictions, and ITT funded our cash disbursements out of the balance of our cash investments with ITT. Since February 5, 1998, we have been performing our own cash management

functions and no longer have any cash invested with ITT. Our net cash items (consisting until February 5, 1998 of cash and cash equivalents, restricted cash and cash invested with ITT, and since February 5, 1998 of cash and cash equivalents, restricted cash and marketable debt securities) increased from \$98.7 million at December 31, 1997 to \$119.3 million at December 31, 1998. Marketable debt securities and cash equivalents ranged from a low of \$67.3 million in June 1998 to a high of \$124.5 million in November 1998.

We have generated positive cash flows from operations for the past five years. Cash flows from operations, excluding the \$38.3 million increase in marketable debt securities, in 1998 was \$31.9 million, an increase of \$17.5 million from \$14.4 million in 1997. This increase was primarily due to lower cash flows from operations in 1997 caused by the decrease in deferred tuition revenue resulting from the July 1, 1997 regulatory change that affects when we receive federal student loan funds, as discussed above, and the unpaid portion of the legal settlement. Cash flows from operations in 1997 was \$14.4 million, a decrease of \$11.7 million from \$26.1 million in 1996. This decrease was primarily due to the decrease in deferred tuition revenue resulting from the July 1, 1997 regulatory change that affects when we receive federal student loan funds, as discussed above.

At December 31, 1998, we had positive working capital of \$68.5 million. Giving effect to the stock repurchase, we would have had positive working capital of \$19.4 million at December 31, 1998. Deferred tuition revenue, which represents the unrecognized portion of tuition revenue received from students, was \$32.3 million at December 31, 1998.

An institution may lose its eligibility to participate in some or all Title IV Programs if the rates at which the institution's students default on federal student loans exceed specific percentages. An institution whose cohort default rate on loans under the Federal Family Education Loan ("FFEL") program and the William D. Ford Federal Direct Loan ("FDL") program is 25% or greater for three consecutive federal fiscal years loses eligibility to participate in those programs for the remainder of the federal fiscal year in which the DOE determines that the institution has lost its eligibility and for the two subsequent federal fiscal years. In addition, amendments to the HEA enacted in connection with the U.S. Congress' reauthorization of the HEA in October 1998 (the "1998 HEA Amendments") provide that if an institution becomes ineligible to participate in the FFEL and FDL programs following the publication of its 1996 (or any subsequent) federal fiscal year FFEL/FDL cohort default rate, the institution will also be ineligible to participate in the Federal Pell Grant ("Pell") program for the same period of time.

None of our campus groups (defined as the main campus and its additional locations or branch campuses) had an FFEL/FDL cohort default rate equal to or greater than 25% for the 1996 federal fiscal year, the most recent year for which the DOE has published FFEL/FDL cohort default rates. In June 1998, our institute in Garland, Texas became ineligible to participate in the FFEL and FDL programs, because it had FFEL/FDL cohort default rates exceeding 25% for three consecutive federal fiscal years beginning with the 1993 federal fiscal year. The Garland institute accounted for approximately 1.4% of our revenues in 1998. The Garland institute can reapply to the DOE to regain its eligibility to participate in the FFEL and FDL programs on or after October 1, 2000. We have arranged for an unaffiliated private funding source to provide loans to the students enrolled in the Garland institute. This alternative financing source requires us to guarantee repayment of the loans it issues. Based on our experience with the repayment of Title IV Program loans by students who attended the Garland institute, we believe that such guaranty should not result in a material adverse effect on our financial condition, results of operations or cash flows. We have also decided to stop enrolling new students in the Garland institute, at least temporarily, while we continue teaching the students already enrolled. We are considering whether to close the Garland institute once the students already enrolled have completed their programs of study or transferred to another school.

Prior to the 1998 HEA Amendments, the HEA limited how much an institution could charge a student who withdrew from the institution. A student was only obligated for a pro rata portion of the education costs charged by the institution, if the student withdrew during the first 60% of the student's first period of enrollment. For our institutes, a period of enrollment is generally an academic quarter. A student who withdrew after the first period of enrollment was also subject to a refund calculation, but it was not a straight pro rata calculation. The institution had to refund any monies it collected in excess of the pro rata or other applicable portion to the appropriate lenders or Title IV Programs in a particular order.

The 1998 HEA Amendments rescinded the limitation on how much an institution can charge a withdrawing student, but the standards of most state education authorities that regulate our institutes (the "SEAs") and the two accrediting commissions that accredit our institutes (the "Accrediting Commissions") continue to impose such a limitation. The 1998 HEA Amendments imposed a limit on the amount of Title IV Program funds a withdrawing student can use to pay his or her education costs. This new limitation permits a student to use only a pro rata portion of the Title IV Program funds that the student would otherwise be eligible to use, if the student withdraws during the first 60% of any period of enrollment. The institution must refund to the appropriate lenders or Title IV Programs any Title IV Program funds that the institution receives on behalf of a withdrawing student in excess of the amount the student can use for such period of enrollment. The new refund requirements contained in the 1998 HEA Amendments become effective in October 2000, but an institution may elect to begin complying with these new standards at an earlier date. We do not plan to elect to comply with these new standards prior to October 2000.

Depending on the refund policies of the applicable SEAs and Accrediting Commission, in a variety of instances withdrawing students will still be obligated to the institution under the new HEA refund requirements for education costs that the students can no longer pay with Title IV Program funds. In these instances, we expect that many withdrawing students will be unable to pay such costs

and that we will be unable to collect a significant portion of such costs. Title IV Program funds are generally paid sooner and are more collectible than tuition payments from other sources. As a result, if the new refund requirements remain unchanged, they could have a material adverse effect on our financial condition, results of operations and cash flows beginning with our 2001 fiscal year.

A for-profit institution, such as each of our campus groups, becomes ineligible to participate in Title IV Programs if, on a cash accounting basis, the institution derives more than 85% of its applicable revenues for a fiscal year from Title IV Programs. For each of our 1997 and 1998 fiscal years, none of our campus groups derived more than 79% of its revenues from Title IV Programs. For our 1998 fiscal year, the range of our campus groups was from approximately 58% to approximately 79%. The 1998 HEA Amendments increased the percentage of applicable revenues that a for-profit institution can derive from Title IV Programs from 85% to 90%. The DOE has indicated orally that it will apply this amendment beginning with our 1998 fiscal year. The 5% increase in the percentage of applicable revenues that we can derive from Title IV Programs will increase the aggregate amount of Title IV Program funds that students can use to pay their education costs of attending our institutes. Title IV Program funds are generally paid sooner and are more collectible than tuition payments from other sources. As a result, this 5% increase should have a positive impact on our results of operations and cash flows beginning in our 1999 fiscal year.

The DOE, the Accrediting Commissions and most of the SEAs have laws, regulations and/or standards (collectively "Regulations") pertaining to the change in ownership and/or control (collectively "change in control") of institutions, but these Regulations do not uniformly define what constitutes a change in control. When a change in control occurs under the DOE's Regulations, an institution immediately becomes ineligible to participate in Title IV Programs and can only receive and disburse certain Title IV Program funds that were previously committed to its students, until it has applied for certification and is reinstated by the DOE to continue Title IV Program participation under its new ownership and control. The DOE's Regulations also require that all of our institutes in a particular campus group have their state authorizations and accreditations reaffirmed or reestablished before any institute in that campus group can regain its eligibility from the DOE.

On February 1, 1999, ITT sold 7,950,000 shares of our common stock in a public offering (the "February 1999 Offering"). The February 1999 Offering was not a change in control under the Regulations of the DOE or the Accrediting Council for Independent Colleges and Schools, which accredits three of our institutes, but the February 1999 Offering was a change in control under the Regulations of some of the SEAs. The Accrediting Commission of Career Schools and Colleges of Technology ("ACCSCT"), which accredits 61 of our institutes, advised us that it was unnecessary for it to determine whether the February 1999 Offering would be a change in control under its Regulations, and that none of our institutes' accreditation by the ACCSCT would be affected by the February 1999 Offering. As a result, the February 1999 Offering will not affect our ability to participate in Title IV Programs, unless any SEA or SEAs that considered the February 1999 Offering to be a change in control fail to reauthorize any of our institutes. Many SEAs require that they approve a change in control before it occurs, while others will only review a change in control after it occurs. We obtained all of the approvals of the February 1999 Offering from the SEAs that require advance approval. We are pursuing and believe that we will be able to obtain all of the approvals from the SEAs that require approval after the February 1999 Offering occurred, but we cannot assure you that we will receive all of these approvals in a timely manner. A material adverse effect on our financial condition, results of operations and cash flows could result if we are unable to obtain these approvals or if we do not obtain these approvals in a timely manner. The California SEA, which normally requires advance approval, advised us that it would not determine whether the February 1999 Offering was a change in control until after the consummation of the February 1999 Offering. It also advised us that the provisions of the California Education Code that provide for termination of its existing authorization of our California institutes if advance approval is not obtained would not apply to the February 1999 Offering. Eleven of our institutes are located in California. We are pursuing a determination from the California SEA whether the February 1999 Offering was a change in control under its standards.

A change in control could occur as a result of future transactions in which we, our institutes or a parent company as defined in DOE regulations are involved. Some corporate reorganizations and some changes in the boards of directors of such corporations are two examples of such transactions. A material adverse effect on our financial condition, results of operations and cash flows would result if we had a change in control and a material number of our institutes failed, in a timely manner, to be reauthorized by their SEAs, reaccredited by their Accrediting Commissions or recertified by the DOE to participate in Title IV Programs.

Our capital assets consist primarily of classroom and laboratory equipment (such as computers, electronic equipment and robotic systems), classroom and office furniture and leasehold improvements. We lease all our building facilities. Capital expenditures totaled \$11.4 million during 1998 and included expenditures of \$2.2 million for new technical institutes, \$2.9 million to expand curricula offerings at existing institutes, \$4.8 million to replace or add furniture or equipment at existing institutes and \$1.5 million on leasehold improvements. Leasehold improvements represent part of our continuing effort to maintain our existing facilities in excellent condition. Capital expenditures decreased by \$0.1 million to \$11.4 million in 1998 from \$11.5 million in 1997, principally due to the expenditure of approximately \$3.0 million for the acquisition of new computers in 1997 offset by the expenditures for new institutes opened in 1998. New institutes have large capital additions in the first two years. To date, cash generated from operations has been sufficient to meet our capital expenditures.

We plan to continue to upgrade and expand current facilities and equipment. We expect that 1999 capital expenditures will be approximately \$17.0 million, of which approximately \$7 million would be capital expenditures for new curriculum at existing institutes. The capital additions for a new institute are approximately \$0.4 million and the capital expenditures for each new curriculum at an existing institute are approximately \$0.3 million. We anticipate that our planned capital additions can be funded from cash flows from operations. Cash flows on a long-term basis are highly dependent upon the receipt of Title IV Program funds and the amount of funds spent on new institutes, curricula additions at existing institutes and possible acquisitions.

We believe that the reduction in cash and cash equivalents and marketable debt securities that were used to effect the stock repurchase will not have a material adverse effect on our expansion plans, planned capital expenditures, ability to meet any applicable regulatory financial responsibility standards, or ability to conduct normal operations.

Year 2000 Compliance

The Year 2000 Problem. Many information technology ("IT") hardware and software systems ("IT Systems") and non-IT Systems containing embedded technology, such as microcontrollers and microchip processors ("Non-IT Systems") can only process dates with six digits (e.g., 06/26/98), instead of eight digits (e.g., 06/26/1998). This limitation may cause IT Systems and Non-IT Systems to experience problems processing information with dates after December 31, 1999 (e.g., 01/01/00 could be processed as 01/01/2000 or 01/01/1900) or with other dates, such as September 9, 1999, which was a date traditionally used as a default date by computer programmers. These problems may cause IT Systems and Non-IT Systems to suffer miscalculations, malfunctions or disruptions. These problems are commonly referred to as "Year 2000" or "Y2K" problems. We are unable at this time to assess the possible impact on our financial condition, results of operations and cash flows that may result from any disruptions to our business caused by Y2K problems in any IT Systems and Non-IT Systems that we control or that any third party with whom we have a material relationship controls. We do not believe at the current time, however, that the cost to remedy our internal Y2K problems will have a material adverse effect on our results of operations or cash flows.

Our State of Readiness. We have begun to implement a plan to ensure that the IT Systems and material Non-IT Systems that we control are Y2K compliant before January 1, 2000. In the first phase of the plan, we assessed the potential exposure of our IT Systems and material Non-IT Systems to Y2K problems. We have completed this phase. In the second phase, which we have also completed, we designed a procedure to remediate our exposure to Y2K problems in the IT Systems and material Non-IT Systems that we control. We are currently in the third phase, which involves the actual remediation of the IT Systems and material Non-IT Systems that we control. After we complete the third phase, we will begin the fourth and final phase of testing the remediation to the IT Systems and material Non-IT Systems that we control to ensure Y2K compliance. We plan to complete the testing phase by June 30, 1999.

We believe that we have identified all IT Systems and material Non-IT Systems that we control that may require Y2K remediation. We have 12 people (both employees and outside consultants) dedicated to completing enhancements to our IT Systems, which include our accounting, human resources, financial services, admissions, education, recruitment and career services systems. We have been enhancing our IT Systems on a continuous basis since 1996 and we did not accelerate these enhancements due to any Y2K problems. These enhancements will also address the Y2K problems with our IT Systems. We plan to complete these enhancements by April 30, 1999.

We have dedicated two employees to either remediate or cause the remediation of material Non-IT Systems that we control and that we have identified as possessing a Y2K problem. We plan to complete the remediation of these Non-IT Systems by April 30, 1999. We acquired many of these Non-IT Systems during the past few years and we believe that a substantial number of these newer systems do not possess a Y2K problem. In addition, the vendors of many of these Non-IT Systems have warranted them to be Y2K compliant. We have contacted the third parties who control our other material Non-IT Systems (including, without limitation, our communication systems, security systems, electrical systems and HVAC systems) to assess whether any of these systems possess a Y2K problem that could adversely affect our operations if a malfunction occurred. We have also implemented procedures to help ensure that any new Non-IT Systems that we acquire or utilize are Y2K compliant.

We have identified and begun to contact the third parties whose lack of Y2K compliance may pose problems for us, such as federal and state regulators, Accrediting Commissions, guaranty agencies, lenders, computer software and hardware suppliers and book vendors. The General Accounting Office reported in September 1998 that the DOE's delay in addressing the Y2K problems in its IT Systems and the DOE's limited progress in making contingency plans should its IT Systems fail could result in serious disruptions in the DOE's administration of, and disbursement of funds under, Title IV Programs. In the DOE's January 15, 1999 status report on Y2K compliance of its mission-critical IT systems, the DOE stated that 12 of its 14 mission-critical IT Systems are Y2K compliant. According to this report, the DOE's IT System that tracks FFEL program loans is the only DOE IT System relating to federal student financial aid that is not Y2K compliant. The DOE reported that this IT System will be Y2K compliant by March 31, 1999.

The Costs to Address Our Year 2000 Issues. We have expended approximately \$25,000 in direct costs through December 31, 1998 to identify and remediate our Y2K problems. This amount does not include:

- the salaries of our employees involved in the remediation process;
- the cost of the enhancements to our IT Systems, because we did not accelerate the enhancements due to Y2K problems; and
- the cost to us of replacing any Non-IT Systems or acquiring any new Non-IT Systems in the normal course of our operations and not because of any Y2K problems.

Based on our current assessment of our Y2K problems, we estimate that our remediation efforts will cost between \$50,000 and \$100,000 for the IT Systems and material Non-IT Systems that we control to become Y2K compliant, representing up to 10% of our IT budget. Approximately 75% of this amount will be used, if necessary, to replace computer hardware and software and other Non-IT Systems equipment owned by us at our institutes. This amount does not include any costs associated with remediating any Y2K problems suffered by any third parties' IT Systems and Non-IT Systems that may affect our operations. Our operations will fund our Y2K remediation efforts.

The Risks Associated With Our Year 2000 Issues. The remediation of our Y2K problems will increasingly cause us to defer some existing and contemplated projects, particularly those involving our personnel conducting the Y2K remediation. Although we are unable at this time to quantify our internal indirect costs resulting from our Y2K problems, we do not believe that the cost of remediating our internal Y2K problems or the lost opportunity costs arising from diverting the efforts of our personnel to the remediation will have a material adverse effect on our financial condition, results of operations or cash flows. We do not intend to use any independent verification or validation processes to assure the reliability of our risk or cost estimates associated with our Y2K problems.

We have begun to outline several possible worst case scenarios that could arise from our Y2K problems. At this time, however, we have insufficient information to assess the likelihood of any worst case scenario. Our most reasonably likely worst case Y2K scenarios involve:

- significant delays in our receipt of federal and state student financial aid in payment of students' education costs of attending our institutes;
- significant delays or interruptions in the eligibility to participate in Title IV Programs, approval to operate or accreditation of our institutes that are undergoing their initial, or a renewal of, such eligibility, approval or accreditation; and
- significant delays in obtaining authorization to offer new programs of study for which our institutes have applied.

In 1998, we derived approximately 69% of our revenues from Title IV Programs administered by the DOE. In addition, a number of our institutes participate in various state student financial aid programs administered by SEAs that, in the aggregate, generate a material portion of our revenues. In 1998, one lender provided approximately 65% of all FFEL program loans received by our students, and one student loan guaranty agency guaranteed approximately 94% of all FFEL program loans received by our students. As a result, we must depend on the ability of the DOE, the SEAs and our primary student loan lender and guaranty agency to resolve their Y2K problems. If any of these parties were to experience a Y2K problem that significantly delays our receipt of federal or state student financial aid in payment of students' education costs, it could have a material adverse effect on our financial condition, results of operations and cash flows. Similarly, an interruption in our institutes' operations could occur if, due to a Y2K problem:

- the DOE is unable to timely grant or renew an institute's eligibility to participate in Title IV Programs;
- any SEA is unable to timely approve an institute to operate or renew such approval; or
- either Accrediting Commission is unable to timely accredit an institute or renew such accreditation.

A prolonged delay or interruption for a significant number of institutes could have a material adverse effect on our financial condition, results of operations and cash flows. We are unable to independently assess the Y2K readiness of any of these third parties at this time.

Contingency Plan. We have developed a contingency plan for the IT Systems and material Non-IT Systems that we control. We have dedicated two employees to remediate an IT System that will become obsolete after we finish the enhancements to our IT Systems. We plan to complete the remediation of this IT System by March 31, 1999. If the enhancements to our IT Systems are not finished before January 1, 2000, we hope to avoid any disruption to our business by using this other IT System. Our contingency plan with respect to the material Non-IT Systems that we control includes, among other things, investigating the availability and replacement cost of such Non-IT Systems that have Y2K problems, isolating such systems that are not Y2K compliant so that they do not affect other systems, and adjusting the clocks on such Non-IT Systems that are not date sensitive. We believe that we could substitute other student loan lenders and guaranty agencies for our primary lender and guaranty agency if either of these parties experienced a Y2K problem that could significantly delay our receipt of federal or state student financial aid in payment of students' education costs of attending our institutes. Our current financial resources would also help us weather any such delay. Otherwise, we have no contingency plan, and do not intend to create a contingency plan, for the IT Systems and Non-IT Systems that are not controlled by us, including the third party IT Systems of the DOE, the SEAs and the Accrediting Commissions on which we rely.

New Accounting Pronouncements

The American Institute of Certified Public Accountants (the "AICPA") issued Statement of Position ("SOP") 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use," in March 1998. SOP 98-1 provides guidance on accounting for the costs of computer software developed or obtained for internal use and requires us to capitalize costs incurred in the application development stage (whether internal or external). Costs incurred prior to initial application of this SOP, whether or not capitalized, should not be adjusted to the amounts that would have been capitalized had this SOP been in effect when those costs were incurred. We adopted this SOP in July 1998, effective as of January 1, 1998, which increased net income by \$0.5 million (\$0.02 per share) in the year ended December 31, 1998.

Additionally, the AICPA issued SOP 98-5, "Reporting on the Costs of Start-Up Activities," in April 1998. SOP 98-5 provides guidance on the financial reporting of start-up costs and requires the cost of start-up activities to be expensed as incurred. This SOP is applicable to all financial statements for fiscal years beginning after December 15, 1998. Initial application should be reported as a cumulative effect of a change in accounting principle as described in Accounting Principles Board Opinion No. 20, "Accounting Changes." We intend to adopt this standard in the first quarter of 1999. Approximately \$0.8 million, net of tax, will be recorded as a change in accounting principle in the first quarter of 1999.

Factors That May Affect Future Results

This annual report contains certain forward looking statements that involve a number of risks and uncertainties. Among the factors that could cause actual results to differ materially are the following: business conditions and growth in the postsecondary education industry and in the general economy; changes in federal and state governmental regulations with respect to education and accreditation standards, or the interpretation or enforcement thereof, including, but not limited to, the level of government funding for, and ESI's eligibility to participate in, student financial aid programs utilized by our students; the consummation of the proposed settlements of student litigation and claims related to our technology programs in California and our hospitality programs; effects of any change in ownership of ESI resulting in a change in control of ESI, including, but not limited to, the consequences of such changes on the accreditation and federal and state regulation of the institutes; receptivity of students and employers to our existing program offerings and new curricula; and loss of lender access to our students for student loans.

REPORT OF INDEPENDENT ACCOUNTANTS

To the Board of Directors and Shareholders of ITT Educational Services, Inc.

In our opinion, the accompanying balance sheets and the related statements of income and retained earnings and of cash flows present fairly, in all material respects, the financial position of ITT Educational Services, Inc. at December 31, 1998 and 1997, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 1998, in conformity with generally accepted accounting principles. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with generally accepted auditing standards which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for the opinion expressed above.



PricewaterhouseCoopers LLP
Indianapolis, Indiana
January 9, 1999

ITT Educational Services, Inc. Statements of Income and Retained Earnings

(In thousands, except per share data)

Years Ended December 31,	1998	1997	1996
Revenues			
Tuition	\$248,399	\$222,457	\$196,692
Other educational	42,976	39,207	35,627
Total revenues	291,375	261,664	232,319
Costs and Expenses			
Cost of educational services	176,487	163,053	145,197
Student services and administrative expenses	81,522	72,388	66,546
Legal settlement	12,858	-	-
Offering, change in control and other one-time expenses	1,872	-	-
Total costs and expenses	272,739	235,441	211,743
Operating income	18,636	26,223	20,576
Interest income, net	5,329	5,565	4,119
Income before income taxes	23,965	31,788	24,695
Income taxes	10,024	12,665	9,844
Net income	13,941	19,123	14,851
Retained earnings, beginning of period	55,032	35,909	21,058
Retained earnings, end of period	\$ 68,973	\$ 55,032	\$ 35,909
Earnings per common share			
Basic	\$ 0.52	\$ 0.71	\$ 0.55
Diluted	\$ 0.51	\$ 0.71	\$ 0.55

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

ITT Educational Services, Inc.

Balance Sheets

(In thousands, except per share data)

December 31,	1998	1997
Assets		
Current assets		
Cash and cash equivalents	\$ 77,335	\$ 29
Restricted cash	3,617	3,860
Cash invested with ITT Corporation	–	94,800
Marketable debt securities	38,316	–
Accounts receivable, less allowance for doubtful accounts of \$2,531 and \$1,393	10,772	9,680
Deferred income tax	5,969	2,019
Prepays and other current assets	2,749	2,570
Total current assets	138,758	112,958
Property and equipment, net	24,985	22,886
Direct marketing costs	7,915	6,882
Other assets	3,913	3,188
Total assets	\$175,571	\$145,914
Liabilities and Shareholders' Equity		
Current liabilities		
Accounts payable	\$ 15,992	\$ 14,974
Accrued compensation and benefits	6,488	3,245
Accrued legal settlements	7,604	–
Other accrued liabilities	7,896	6,877
Deferred tuition revenue	32,261	30,850
Total current liabilities	70,241	55,946
Other liabilities	3,474	2,153
Total liabilities	73,715	58,099
Commitments and contingent liabilities (Note 10)		
Shareholders' equity		
Preferred stock, \$0.01 par value, 5,000,000 shares authorized, none issued or outstanding	–	–
Common stock, \$0.01 par value, 50,000,000 shares authorized, 27,011,202 and 26,999,952 issued and outstanding	270	270
Capital surplus	32,613	32,513
Retained earnings	68,973	55,032
Total shareholders' equity	101,856	87,815
Total liabilities and shareholders' equity	\$175,571	\$145,914

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

ITT Educational Services, Inc.

Statements of Cash Flows

(In thousands)

Years Ended December 31,	1998	1997	1996
Cash flows from operating activities:			
Net income	\$ 13,941	\$ 19,123	\$ 14,851
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	9,282	7,939	7,493
Provision for doubtful accounts	4,326	2,354	1,738
Deferred taxes	(3,219)	202	(443)
Increase/decrease in operating assets and liabilities:			
Marketable debt securities	(38,316)	–	–
Accounts receivable	(5,418)	(2,656)	(3,524)
Direct marketing costs	(1,033)	(1,108)	(743)
Accounts payable and accrued liabilities	13,474	2,958	3,083
Prepays and other assets	(904)	(1,769)	220
Deferred tuition revenue	1,411	(12,682)	3,469
Net cash provided by (used for) operating activities	(6,456)	14,361	26,144
Cash flows used for investing activities:			
Capital expenditures, net	(11,381)	(11,465)	(7,868)
Net decrease (increase) in cash invested with ITT Corporation	94,800	(4,992)	(17,923)
Net cash provided by (used for) investing activities	83,419	(16,457)	(25,791)
Cash flow provided by finance activities:			
Exercise of stock options	100	–	–
Net increase (decrease) in cash, cash equivalents and restricted cash	77,063	(2,096)	353
Cash, cash equivalents and restricted cash at beginning of period	3,889	5,985	5,632
Cash, cash equivalents and restricted cash at end of period	\$ 80,952	\$ 3,889	\$ 5,985
Supplemental disclosure of cash flow information:			
Cash paid during the period for:			
Income taxes	\$ 12,757	\$ 12,352	\$ 10,051
Interest	238	291	273

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

ITT EDUCATIONAL SERVICES, INC.

NOTES TO FINANCIAL STATEMENTS

December 31, 1998, 1997 and 1996

(Dollar amounts in thousands, unless otherwise stated)

1. Ownership and Change in Control

From ITT Educational Services, Inc.'s (the "Company") initial public offering in 1994 until June 9, 1998, ITT Corporation ("ITT") owned 83.3% of the outstanding common stock of the Company.

On February 23, 1998, Starwood Hotels & Resorts Worldwide, Inc. ("Starwood Hotels") completed the acquisition of ITT (the "Merger") and ITT became a subsidiary of Starwood Hotels. As a result of the Merger, a change in control of the Company occurred under regulations of the U.S. Department of Education ("DOE") and each ITT Technical Institute campus group became ineligible to participate in federal student financial aid programs. Effective March 20, 1998, the eligibility of each ITT Technical Institute campus group to participate in federal student financial aid programs was reinstated by the DOE with certain conditions imposed by the DOE. The Company believes that it is in compliance with or satisfies these DOE conditions.

On June 9, 1998, ITT sold 13,050,000 shares of the Company's common stock held by ITT to the public (48.3% of the outstanding shares) (the "June 1998 Offering"). ITT presently owns 35% of the outstanding shares of the Company's common stock. The June 1998 Offering did not constitute a change in control under the DOE's regulations. In December 1998, the Company filed a registration statement with the Securities and Exchange Commission, which was not effective as of December 31, 1998, relating to the offering of shares of the Company's common stock to the public (the "February 1999 Offering"). The February 1999 Offering contemplates the sale of 7,000,000 shares, together with an underwriters' over-allotment option to purchase up to 950,000 additional shares of the Company's common stock held by ITT. The February 1999 Offering does not constitute a change in control under the DOE's regulations. Simultaneous with the close of the February 1999 Offering, the Company intends to repurchase 1,500,000 shares of its common stock from ITT at an aggregate cost not to exceed \$49,260.

2. Summary of Accounting Principles and Policies

Business Activities. The Company is a leading proprietary postsecondary education system primarily offering career-focused, technical degree programs of study. At December 31, 1998, the Company operated 65 technical institutes throughout the United States. The Company maintains its corporate headquarters in Indianapolis, Indiana.

Use of Estimates. The preparation of these financial statements, in conformity with generally accepted accounting principles, includes estimates that are determined by the Company's management.

Cash Equivalents and Marketable Debt Securities.

Marketable debt securities are classified as trading securities and have maturity dates in excess of 90 days at the time of purchase and are recorded at their market value. Debt securities with maturity dates less than 90 days at the time of purchase are included in cash and cash equivalents and are recorded at cost, which approximates market value. The cost of securities sold is based on the first-in, first-out method.

Investment income for the year ended December 31, 1998 consists of:

Net realized gains on the sale of trading securities	\$ 11
Interest and dividend income, net	4,926
Change in net unrealized holding gain	85
	<u>\$ 5,022</u>

Property and Equipment. The Company includes all property and equipment in the financial statements at cost. Provisions for depreciation of property and equipment have generally been made using the straight-line method for financial reporting purposes and accelerated methods for tax purposes. Estimated useful lives generally range from three to ten years for furniture and equipment and leasehold improvements. Maintenance, repairs and renewals not of a capital nature are expensed as incurred. Fully depreciated assets no longer in use are removed from both the asset and accumulated depreciation accounts in the year of their retirement. Any gains or losses on dispositions are credited or charged to income, as appropriate.

Fair Value of Financial Instruments. The carrying amounts reported in the balance sheets for cash and cash equivalents, restricted cash, cash invested with ITT Corporation, accounts receivable, accounts payable, other accrued liabilities and deferred tuition revenue approximate fair value because of the immediate or short-term maturity of these financial instruments. Marketable debt securities are recorded at their market value.

Recognition of Revenues. Tuition revenues are recorded on a straight-line basis over the length of the applicable course. If a student discontinues training, the revenue related to the remainder of that academic quarter is recorded with the amount of refund resulting from the application of federal, state or accreditation requirements recorded as an expense. On an individual student basis, tuition earned in excess of cash received is recorded as accounts receivable, and cash received in excess of tuition earned is recorded as deferred tuition revenue.

Other educational revenues are comprised of laboratory fees and textbook sales. Laboratory fees are recorded as revenue at the beginning of each academic quarter. Textbook sales are recognized when they occur.

Advertising Costs. The Company expenses all advertising costs as incurred.

Direct Marketing Costs. Direct costs incurred relating to the enrollment of new students are capitalized using the successful efforts method. Direct marketing costs include recruiting representatives' salaries, employee benefits and other direct costs less enrollment fees. Direct marketing costs are amortized on an accelerated basis over the average course length of 24 months commencing on the start date. Direct marketing costs on the balance sheet totaled \$7,915 and \$6,882 at December 31, 1998 and December 31, 1997, respectively, net of accumulated amortization of \$6,895 and \$5,861 at those dates, respectively.

Institute Start-Up Costs. Deferred institute start-up costs consist of all direct costs (excluding advertising costs) incurred at a new institute from the date a lease for a technical institute facility is entered into until the first class start. Such capitalized costs are amortized on a straight-line basis over a one-year period. At December 31, 1998 and December 31, 1997, deferred start-up costs included in other assets in the balance sheet totaled \$1,353 and \$1,316, respectively, net of accumulated amortization of \$511 and \$174 at such dates, respectively. In conformity with Statement of Position ("SOP") 98-5, "Reporting on the Costs of Start-Up Activities," the Company intends to expense the \$1,353 of institute start-up costs, less \$531 of deferred taxes, as a cumulative effect of a change in accounting principle in the first quarter of 1999.

Offering, Change in Control and Other One-Time Expenses. The Company incurred total expenses for the June 1998 Offering of \$1,117. In addition, the Company incurred expenses of \$755 associated with its change in control and establishment of new employee benefit plans.

Costs of Computer Software Developed or Obtained for Internal Use. The American Institute of Certified Public Accountants (the "AICPA") issued SOP 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use," in March 1998. SOP 98-1 provides guidance on accounting for costs of computer software developed or obtained for internal use and requires costs incurred in the application development stage (whether internal or external) to be capitalized. Costs incurred prior to initial application of this SOP, whether or not capitalized, should not be adjusted to the amounts that would have been capitalized had this SOP been in effect when those costs were incurred. The Company adopted this SOP effective July 1, 1998, which increased net income by \$508 (\$0.02 per share) in the year ended December 31, 1998.

Income Taxes. The Company was included in the consolidated U.S. federal income tax return of ITT prior to June 9, 1998 and determined its income tax provision principally on a separate return basis in conformity with Statement of Financial Accounting Standards ("SFAS") No. 109. Under a tax sharing policy with ITT, income taxes were allocated to members of the U.S. consolidated group based principally on the amounts they would pay or receive if they filed a separate income tax return. Deferred income taxes were provided on the differences in the book and tax basis of assets and liabilities recorded on the books of the Company (temporary differences) at the statutory tax rates expected to be in effect when such differences reversed. Temporary differences related to SFAS No. 106, SFAS No. 112, pension and self-insurance costs were recorded on the books of ITT where the related assets and liabilities were recorded. ITT paid current federal income taxes on behalf of the Company, as calculated under the tax sharing policy, and reflected the funding through the cash invested with ITT Corporation account.

Beginning June 9, 1998, the Company started filing its own federal income tax returns, paying its own federal income taxes and recording all deferred income taxes on its books.

Earnings Per Common Share. Earnings per common share for all periods have been calculated in conformity with SFAS No. 128, "Earnings Per Share." Such data is based on historical net income and the average number of shares of the Company's common stock outstanding during each period. The number of average shares outstanding utilized for basic earnings per share were 27,001,542 in 1998 and 26,999,952 in 1997 and 1996. Average shares outstanding utilized for diluted earnings per share were approximately 27,185,000, 27,105,000 and 27,092,000 for 1998, 1997 and 1996, respectively. The difference in shares utilized in calculating basic and diluted earnings per share represents the average number of shares issued under the Company's stock option plan less shares assumed to be purchased with proceeds from the exercise of the stock options.

3. Related Party Transactions

At December 31, 1998, and during the three-year period then ended, the relationship between the Company and ITT was governed by various agreements summarized as follows:

Intercompany Activities. ITT provided the Company with certain centralized treasury and financing functions. The Company transferred all unrestricted cash receipts to ITT and received funds from ITT for all disbursements. The Company earned interest on the average net cash balance held by ITT, at an interest rate that was set for a 12-month period and was 30 basis points over the most recently published rate for 12-month treasury bills. The net of all such cash transfers as well as charges from ITT for expenses related to the Company's participation in ITT's plans (such as pensions, medical insurance,

federal income taxes, etc.) resulted in a net balance of cash invested with ITT of \$94,800 at December 31, 1997. On February 5, 1998, ITT transferred approximately \$83,000 to the Company and, since that date, the Company has been performing its own cash management function.

ITT also provided certain risk management and pension management services to the Company until June 9, 1998. The fee (contract service charge) for such services was 0.25% of the Company's annual revenue. The contract service charges were \$15, \$654 and \$578 for the years ended December 31, 1998, 1997 and 1996, respectively.

The Company's employees participated in certain employee benefit programs which were sponsored and administered by ITT until June 9, 1998. Administrative costs relating to these services and participation in these plans were charged to the Company using allocation methods management believes were reasonable. The Company paid a processing fee related to its participation in ITT's consolidated medical plan. The processing fees were \$159 and \$280 in 1997 and 1996, respectively.

Tax Agreement. ITT and the Company participated in a tax agreement that provided, among other things, that the Company would pay ITT, with respect to federal income taxes for each period that the Company was included in ITT's consolidated federal return, the amount that the Company would have been required to pay had it filed a separate federal income tax return under the tax sharing policy described in Note 2.

Similarly, with respect to state, corporate, franchise or income taxes for those states where ITT filed a combined or consolidated state return that included the Company, the Company paid ITT an amount as if it filed a separate tax return. With respect to ITT's consolidated federal and state returns, the Company will be responsible for any deficiencies assessed with respect to such returns if such deficiencies relate to the Company. Similarly, the Company will be entitled to all refunds paid with respect to such returns that relate to the Company. The Company will be responsible for all taxes, including assessments, if any, for prior years with respect to all other taxes payable by the Company.

Management believes the statements of income include a reasonable allocation of costs incurred by ITT which benefited the Company. The aforementioned agreements were modified in connection with the June 1998 Offering.

4. Financial Aid Programs

The Company participates in various Title IV Programs. Approximately 69% of the Company's 1998 revenue was derived from funds distributed under these programs.

The Company participates in the Federal Perkins Loan ("Perkins") program and administers on behalf of the federal government a pool of Perkins student loans which aggregated \$8,565 and \$8,517 at December 31, 1998 and 1997, respectively.

The Company has recorded in its financial statements only its aggregate mandatory contributions to this program which at December 31, 1998 and 1997 aggregated \$1,581 and \$1,588, respectively. The Company has provided \$972 and \$971, respectively, for potential losses related to funds committed by the Company at December 31, 1998 and 1997.

The Title IV Programs are administered by the Company in separate accounts as required by government regulation. The Company is required to administer the funds in accordance with the requirements of the Higher Education Act of 1965, as amended, and DOE regulations and must use due diligence in approving and disbursing funds and servicing loans. In the event the Company does not comply with federal requirements, or if student loan default rates rise to a level considered excessive by the federal government, the Company could lose its eligibility to participate in the Title IV Programs or could be required to repay funds determined to have been improperly disbursed. Management believes that it is in substantial compliance with the federal requirements.

5. Restricted Cash

The Company participates in the Electronic Funds Transfer ("EFT") program through the DOE. All monies transferred to the Company via the EFT system are subject to certain holding period restrictions, generally from three to seven days, before they can be drawn into the Company's cash account. Such amounts are classified as restricted cash until they are applied to the students' accounts.

6. Property and Equipment

Fixed assets include the following:

December 31,	1998	1997
Furniture and equipment	\$70,581	\$62,514
Leasehold improvements	8,699	7,848
Land and land improvements	110	110
Construction in progress	583	325
	<u>79,973</u>	<u>70,797</u>
Less accumulated depreciation	(54,988)	(47,911)
	<u>\$24,985</u>	<u>\$22,886</u>

7. Taxes

The provision for income taxes includes the following:

Year Ended December 31,	1998	1997	1996
Current			
Federal	\$11,052	\$10,399	\$ 8,673
State	2,191	2,064	1,614
	<u>13,243</u>	<u>12,463</u>	<u>10,287</u>
Deferred			
Federal	(2,686)	168	(370)
State	(533)	34	(73)
	<u>(3,219)</u>	<u>202</u>	<u>(443)</u>
	<u>\$10,024</u>	<u>\$12,665</u>	<u>\$ 9,844</u>

Deferred tax assets (liabilities) include the following:

December 31,	1998	1997	1996
Direct marketing costs	\$(3,105)	\$(2,698)	\$(2,263)
Legal settlements	2,983	-	-
Institute start-up costs	(531)	(516)	(204)
Depreciation	607	759	785
Reserves and other	3,209	2,399	1,828
Net deferred tax assets (liabilities)	<u>\$3,163</u>	<u>\$ (56)</u>	<u>\$ 146</u>

Differences between effective income tax rates and the statutory U.S. federal income tax rates are as follows:

Year Ended December 31,	1998	1997	1996
Statutory U.S. federal income tax rate	35.0%	35.0%	35.0%
State income taxes, net of federal benefit	4.1%	4.1%	4.1%
Non-deductible June 1998			
Offering expenses	1.5%	-	-
Permanent differences and other	1.2%	0.7%	0.8%
Effective income tax rates	<u>41.8%</u>	<u>39.8%</u>	<u>39.9%</u>

8. Retirement Plans

Employee Pension Benefits. Prior to June 9, 1998, the Company participated in the Retirement Plan for Salaried Employees of ITT Corporation which covered substantially all employees of the Company. ITT determined the aggregate amount of pension expense on a consolidated basis based on actuarial calculations and such expense was allocated to participating units on the basis of compensation covered by the plan. Effective June 9, 1998, the Company adopted its own non-contributory defined benefit pension plan. This plan, commonly referred to as a cash balance plan, provides benefits based upon annual employee earnings times established percentages of pay based on age and years of service. Charges to the Company by ITT for pension expense for the years ended December 31, 1998, 1997 and 1996 were \$1,858, \$4,458 and \$3,783, respectively. The net periodic benefit cost for the Company's plan for the year ended December 31, 1998 was comprised of service cost of \$2,217.

The following is information on the Company's plan for 1998:

Change in benefit obligation:

Projected benefit obligation at beginning of period	\$ -
Service cost	2,217
Actuarial loss	527
Projected benefit obligation at end of period	<u>\$ 2,744</u>
Funded status	<u>\$(2,744)</u>
Unrecognized net actuarial loss	527
Accrued benefit cost	<u>\$(2,217)</u>

The accumulated benefit obligation at September 30, 1998 is \$1,551. The plan does not have any assets as of December 31, 1998, and the Company intends to make its first funding contribution to the plan in 1999.

Weighted-average assumptions as of September 30, 1998:

Discount rate	6.5%
Expected return on plan assets	9.0%
Rate of compensation increase	4.5%

Retirement Savings Plan. Prior to May 16, 1998, the Company participated in The ITT 401K Retirement Savings Plan, a defined contribution plan which covered substantially all employees of the Company. The Company's non-matching and matching contributions under this plan were provided for through the issuance of common shares of ITT until February 23, 1998 and paired shares of Starwood Hotels and Starwood Hotels & Resorts, a Maryland real estate investment trust, until May 16, 1998. The costs of the non-matching and matching Company contributions were charged by ITT to the Company. Effective May 16, 1998, the Company adopted its own 401(k) plan, a defined contribution plan which covers substantially all employees of the Company and operates similar to The ITT 401K Retirement Savings Plan. The Company's non-matching and matching contributions under its 401(k) plan are made in the form of shares of the Company's common stock. For the years ended December 31, 1998, 1997 and 1996, the costs of providing this benefit (including an allocation of the administrative costs of the plan) were \$2,109, \$2,104 and 1,749, respectively.

9. Stock Option and Key Employee Incentive Plans

The Company adopted and the stockholders approved the ITT Educational Services, Inc. 1994 Stock Option Plan ("1994 Plan") and the 1997 ITT Educational Services, Inc. Incentive Stock Plan ("1997 Plan"). The Company has adopted the disclosure only provisions of SFAS No. 123, "Accounting for Stock-Based Compensation." Accordingly, no compensation cost has been recognized in the financial statements for the 1994 Plan or the 1997 Plan. The Company has elected, as permitted by the standard, to continue following its intrinsic value based method of accounting for stock options consistent with APB Opinion No. 25, "Accounting for Stock Issued to Employees." Under the intrinsic method, compensation cost for stock options is measured as the excess, if any, of the quoted market price of the Company's common stock at the measurement date over the exercise price.

Under the 1994 Plan, a maximum of 405,000 shares of the Company's common stock may be issued upon exercise of options. Under the 1997 Plan, a maximum of 1.5% of the outstanding common shares may be issued each year commencing in 1997, with any unissued shares issuable in later years.

Under the 1997 Plan, a maximum of 4,050,000 shares of the Company's common stock may be issued upon exercise of options. The option price may not be less than 100% of the fair market value of the Company's common stock on the date of grant and the options will vest and become exercisable in three equal annual installments commencing with the first anniversary of the grant. The options outstanding, granted, exercised and forfeited for the three years ended December 31, 1998 are as follows:

	1998		1997		1996	
	# of Shares	Average Option Price	# of Shares	Average Option Price	# of Shares	Average Option Price
Outstanding at beginning of year	405,000	\$13.46	258,750	\$ 7.37	191,250	\$ 5.75
Granted	405,000	21.69	146,250	24.25	67,500	11.94
Exercised	(11,250)	8.89				
Forfeited	(5,000)	21.69				
Outstanding at end of year	<u>793,750</u>	<u>\$17.67</u>	<u>405,000</u>	<u>\$13.46</u>	<u>258,750</u>	<u>\$ 7.37</u>

	Exercise Price Range			
	\$4.44	\$8.89 – \$11.94	\$21.69 – \$24.25	Total
Options outstanding at year end	135,000	112,500	546,250	793,750
Weighted average exercise price	\$4.44	\$10.72	\$22.38	\$17.67
Remaining contractual life	6 years	7 years	8.8 years	8.1 years
Options exercisable at year end	135,000	90,000	48,750	273,750
Weighted average exercise price	\$4.44	\$10.42	\$24.25	\$9.93

During 1998, the Company issued 11,250 shares of common stock for proceeds of \$100 in conjunction with the exercise of stock options.

Compensation costs for the 1994 Plan, calculated in accordance with SFAS No. 123, are not significant for the year ended December 31, 1996. If compensation costs had been determined based on the fair value of the stock options at grant date consistent with SFAS No. 123, the Company's net income and earnings per share for the years ended December 31, 1998 and 1997 would have been reduced to the proforma amounts indicated below:

Year Ended December 31,	1998	1997
Proforma		
Net income	\$12,554	\$18,519
Basic earning per share	0.46	0.69
Diluted earnings per share	0.46	0.68
As Reported		
Net income	\$13,941	\$19,123
Basic earnings per share	0.52	0.71
Diluted earnings per share	0.51	0.71

The fair value of each option grant was estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions for the three years ended December 31, 1998:

Year Ended December 31,	1998	1997	1996
Risk-free interest rates	5.3%	6.6%	5.7%
Expected lives (in years)	5	10	10
Volatility	41%	46%	46%
Dividend yield	None	None	None

In October 1998, the Compensation Committee of the Board of Directors awarded additional stock options for 409,500 shares of the Company's common stock. The effective date of this award will be the date of the February 1999 Offering and the exercise price will be equal to the offering price of the shares of the Company's common stock sold in the February 1999 Offering.

10. Commitments and Contingent Liabilities

Lease Commitments. The Company leases substantially all of its facilities under operating lease agreements. A majority of the operating leases contain renewal options that can be exercised after the initial lease term. Renewal options are generally for periods of one to five years. All operating leases will expire

over the next 12 years and management expects that leases will be renewed or replaced by other leases in the normal course of business. There are no material restrictions imposed by the lease agreements, and the Company has not entered into any significant guarantees related to the leases. The Company is required to make additional payments under the operating lease terms for taxes, insurance and other operating expenses incurred during the operating lease period.

Rent expense was composed of the following:

Year Ended December 31,	1998	1997	1996
Minimum rentals	\$21,408	\$18,961	\$17,131
Contingent rentals	246	272	249
	<u>\$21,654</u>	<u>\$19,233</u>	<u>\$17,380</u>

Future minimum rental payments required under operating leases that have initial or remaining non-cancelable lease terms in excess of one year as of December 31, 1998 are as follows:

1999	\$ 21,564
2000	\$ 22,798
2001	\$ 19,270
2002	\$ 17,328
2003	\$ 16,300
Later Years	\$ 36,378
	<u>\$133,638</u>

Operating leases related to two institutes that are still in the developmental phase at December 31, 1998 include special clauses that allow the Company to terminate the lease within one year of signing the lease if the new school is not accredited. If this were to occur, the Company would be liable, at the date of termination, for an agreed upon termination cost based on the lessor's tenant improvement costs. The future minimum rental payments schedule above includes such termination costs for the two institutes. If the institutes are accredited as expected, aggregate additional minimum rental payments of \$3,010 will be required over the lease term.

Rent expense and future minimum rental payments related to equipment leases are not material.

Contingent Liabilities. In December 1994, the Company entered into an agreement with an unaffiliated, private funding source to provide loans to students of certain technical institutes. The agreement requires the Company to guarantee repayment of the loans. Outstanding loans at December 31, 1998 aggregated \$1,768. Additionally, the Company is required to maintain on deposit with the lender 15% of the aggregate principal balance of the outstanding loans. This interest bearing deposit is included in other assets in the balance sheet.

The Company has a number of pending legal and other claims arising in the normal course of business. In September 1998, the Company agreed to settle eight legal proceedings (including *Eldredge, et al. v. ITT Educational Services, Inc., et al.*) involving 25 former students and the claims of 15 other former students that related primarily to the Company's marketing and recruitment practices and included allegations of misrepresentation, fraud and violations of certain federal and state statutes. As part of the settlement of these legal proceedings and claims, the Company is seeking court approval of a class settlement of the claims of (a) approximately 1,200 other persons who attended an associate degree program in hospitality at the ITT Technical Institute in Maitland, San Diego, Portland or Indianapolis and (b) approximately 19,000 other persons who attended any technology program at any ITT Technical Institute in California from January 1, 1990 through December 31, 1997. If the Company obtains court approval of the class settlements, the members of each class may still elect to opt out of the settlement and pursue any claims they may have against the Company. The Company recorded a \$12.9 million provision for legal settlements in the year ended December 31, 1998 as a result of the settlement of these legal proceedings and claims.

In the opinion of management, the ultimate outcome of the pending legal and other claims, excluding the settlement discussed above, should not have a material adverse effect on the Company's financial condition, results of operations or cash flows.

ITT Educational Services, Inc.
Selected Financial Data

The following selected financial data of ESI are qualified by reference to and should be read with the Financial Statements and the Notes to the Financial Statements and other financial data included elsewhere in this report.

Year Ended December 31,	1998	1997	1996	1995	1994
<i>(In thousands, except per share and operating data)</i>					
Statement of Income Data:					
Revenue:					
Tuition	\$ 248,399	\$ 222,457	\$ 196,692	\$ 171,936	\$ 159,575
Other educational (a)	42,976	39,207	35,627	29,895	27,332
Total revenues	291,375	261,664	232,319	201,831	186,907
Cost of educational services	176,487	163,053	145,197	130,338	121,594
Student services and administrative expenses	81,522	72,388	66,546	57,268	53,481
Legal settlement	12,858	—	—	—	—
Offering and change in control expenses	1,872	—	—	—	—
Total costs and expenses	272,739	235,441	211,743	187,606	175,075
Operating income	18,636	26,223	20,576	14,225	11,832
Interest income, net (b)	5,329 (c)	5,565	4,119	4,802	232
Income before income taxes	23,965	31,788	24,695	19,027	12,064
Income taxes	10,024	12,665	9,844	7,636	4,902
Net income	\$ 13,941 (c)	\$ 19,123	\$ 14,851	\$ 11,391	\$ 7,162
Earnings per share: (d)					
Basic	\$ 0.52 (c)	\$ 0.71	\$ 0.55	\$ 0.42	\$ 0.32
Diluted	0.51 (c)	0.71	0.55	0.42	0.32
Other Operating Data:					
EBITDA (e)	\$ 27,918	\$ 34,162	\$ 28,069	\$ 21,767	\$ 18,687
Operating losses from new technical institutes before income taxes (f)	\$ 5,257	\$ 3,165	\$ 5,721	\$ 7,123	\$ 7,316
Capital expenditures, net	\$ 11,381	\$ 11,465	\$ 7,868	\$ 8,206	\$ 7,688
Number of students at end of period	25,608	24,498	22,633	20,618	20,668
Number of technical institutes at end of period	65	62	59	56	54
Balance Sheet Data:					
Cash, restricted cash, cash invested with ITT and marketable debt securities	\$ 119,268 (c)	\$ 98,689	\$ 95,793	\$ 77,517	\$ 66,810
Total current assets	138,758	112,958	108,449	87,567	76,460
Property and equipment less accumulated depreciation	24,985	22,886	19,360	18,985	18,321
Total assets	175,571	145,914	135,749	114,284	102,899
Total current liabilities	70,241	55,946	65,405	58,766	57,646
Shareholders' equity	101,856 (c)	87,815	68,692	53,841	42,450

(a) Other educational revenue is comprised of laboratory fees and textbook sales.

(b) See Note 3 of Notes to Financial Statements for information concerning intercompany interest between ESI and ITT. Prior to our initial public offering in December 1994, we did not receive interest on the full amount of net cash balances we invested with ITT and we were assessed an interest charge based on an allocation of the consolidated debt of ITT. After our initial public offering and until February 5, 1998, we received interest from ITT on the amount of any net cash balances we invested with ITT and we were no longer subject to an interest charge based on such an allocation. Since February 5, 1998, we have performed our own cash management functions and no longer have any cash invested with ITT. Lower interest rates on short-term investments have resulted in lower yields on our cash balances than the yields on our cash that was invested with ITT. Accordingly, interest income, net has decreased in 1998.

(c) We spent \$49,088 to repurchase 1,500 shares of our common stock concurrently with the closing of the February 1999 Offering, which would have reduced cash and cash equivalents and marketable debt securities and shareholders' equity by \$49,088 if the repurchase had occurred at December 31, 1998. If the stock repurchase had occurred January 1, 1998, basic and diluted earnings per share for the year ended December 31, 1998 would have been reduced by \$0.04 and \$0.03, respectively, which reflects a reduction in interest income of \$2,700, a reduction in net income of \$1,620 and a reduction in the average number of shares outstanding of 1,500.

(d) Earnings per share data are based on historical net income and the number of shares of our common stock outstanding during each period after giving retroactive effect to the three-for-two stock splits in April and November 1996. Earnings per share for all periods have been calculated in conformity with Statement of Financial Accounting Standards No. 128, "Earnings per Share."

(e) EBITDA represents earnings before interest and financial charges, income taxes, depreciation and amortization. We have included information concerning EBITDA (which is not a measure of financial performance under generally accepted accounting principles) because we understand that certain investors use it as one measure of an issuer's financial performance. EBITDA is not an alternative to operating income (as determined in accordance with generally accepted accounting principles), an indicator of our performance or cash flows from operating activities (as determined in accordance with generally accepted accounting principles) or a measure of liquidity.

(f) Operating losses from new technical institutes before income taxes represents operating losses before income taxes, including amortization of deferred pre-opening costs, for institutes in the first 24 months after their first class start.

ITT Educational Services, Inc.
Quarterly Results for 1997 and 1998 (unaudited)

(In thousands, except per share data)

Three Months Ended

1997	March 31	June 30	Sept. 30	Dec. 31	Year
Revenues	\$ 64,476	\$ 58,412	\$ 73,060	\$ 65,716	\$ 261,664
Cost and expenses	\$ 55,520	\$ 58,263	\$ 60,775	\$ 60,883	\$ 235,441
Operating income	\$ 8,956	\$ 149	\$ 12,285	\$ 4,833	\$ 26,223
Interest income, net	\$ 1,380	\$ 1,193	\$ 1,478	\$ 1,514	\$ 5,565
Net income	\$ 6,202	\$ 805	\$ 8,258	\$ 3,858	\$ 19,123
Earnings per share (basic & diluted)	\$ 0.23	\$ 0.03	\$ 0.30	\$ 0.14	\$ 0.71
1998					
Revenues	\$ 72,287	\$ 65,077	\$ 81,700	\$ 72,311	\$ 291,375
Cost and expenses	\$ 61,317	\$ 66,740	\$ 79,622	\$ 65,060	\$ 272,739
Operating income (1)	\$ 10,970	\$ (1,663)	\$ 2,078	\$ 7,251	\$ 18,636
Interest income, net	\$ 1,244	\$ 1,191	\$ 1,417	\$ 1,477	\$ 5,329
Net income (loss) (1)	\$ 7,328	\$ (660)	\$ 2,097	\$ 5,176	\$ 13,941
Earnings per share (1)					
Basic	\$ 0.27	\$ (0.02)	\$ 0.08	\$ 0.19	\$ 0.52
Diluted	\$ 0.27	\$ (0.02)	\$ 0.08	\$ 0.19	\$ 0.51
Other Operating data:					
Operating losses from new technical institutes before income taxes (2)					
1997	\$ 964	\$ 1,035	\$ 592	\$ 574	\$ 3,165
1998	\$ 1,060	\$ 1,475	\$ 1,338	\$ 1,384	\$ 5,257

(1) Includes one-time expenses of \$14,730 (\$9,216 after taxes) for legal settlements, offering expenses associated with the June 1998 offering of shares of our common stock by ITT, and change in control and other one-time expenses related to Starwood Hotels' acquisition of ITT. Excluding those one-time expenses, operating income, net income and earnings per share for the year ended December 31, 1998, would have been \$33,366, \$23,157 and \$0.85, respectively.

(2) Operating losses from new technical institutes before income taxes represents operating losses before income taxes, including amortization of deferred pre-operating costs, for institutes in the first 24 months after their first class start.

OFFICERS

J. Bradford Rainier has served as Vice President of ESI since January 1993.

Gary L. VonIns has served as Vice President of ESI since December 1996.

Roger A. Booth has served as Vice President of ESI since January 1993.



Thomas W. Lauer has served as Senior Vice President of ESI since January 1993.

Gene A. Baugh has served as Chief Financial Officer of ESI since December 1996 and Senior Vice President of ESI since January 1993. From 1981 through November 1996 he served as Treasurer and Controller of ESI.

Edward G. Hartigan has served as Senior Vice President of ESI since January 1993.

Rene R. Champagne has served as Chairman of ESI since October 1994, President and Chief Executive Officer of ESI since September 1985 and a Director of ESI since October 1985.

Clark D. Elwood has served as Senior Vice President of ESI since December 1996, Secretary of ESI since October 1992 and General Counsel of ESI since May 1991. From January 1993 through November 1996, he served as Vice President of ESI.

BOARD OF DIRECTORS

Rand V. Araskog, age 67, served as chairman and chief executive of ITT from December 1995, and chairman of ITT Sheraton Corporation, a hotel and gaming company, and Caesars World, Inc., a gaming company, from December 1996 until his retirement in February 1998. Mr. Araskog served as chief executive of ITT Corporation, formerly a Delaware corporation and now known as ITT Industries, Inc., an Indiana corporation and ITT's former parent corporation ("Old ITT"), from 1979 to December 1995, chairman of Old ITT from 1980 to December 1995 and president of Old ITT from March 1991 to December 1995. He is also a director of The Hartford Financial Services Group, Inc., ITT Industries, Inc., Alcatel Alsthom of France, Dow Jones & Company, Inc., Rayonier, Inc. and Shell Oil Company. Mr. Araskog has been a Director of ESI since April 1994.

Rene R. Champagne, age 57, has been Chairman of ESI since October 1994, President and Chief Executive Officer of ESI since September 1985 and a Director of ESI since October 1985.

John E. Dean, age 48, is a founding partner of the Washington, D.C. law firm Dean Blakey & Moskowitz, established July 1995. Prior to July 1995, Mr. Dean was a founding partner of the Clohan & Dean law firm, the predecessor to Dean Blakey & Moskowitz. Mr. Dean has been a Director of ESI since December 1994.

James D. Fowler, Jr., age 54, has served as president of Fowler & Associates, a consulting firm based in the Washington, D.C. area, since February 1996, and as executive director and administrator of the Executive Leadership Council and Foundation, a non-profit, non-partisan charitable and educational organization, since October 1997. Mr. Fowler served as director of government and community relations of Old ITT from November 1993 through January 1996. Mr. Fowler has been a Director of ESI since April 1994.

Leslie Lenkowsky, age 52, has been professor of philanthropic studies and public policy at Indiana University since September 1997. Dr. Lenkowsky served as president of Hudson Institute, a public policy research institute, from August 1990 through August 1997. He is also a director of American United Life Pooled Equity Fund B and American United Life American Series Fund. Dr. Lenkowsky has been a Director of ESI since December 1994.

Vin Weber, age 46, has been a partner at Clark & Weinstock Inc., a Washington, D.C. public relations firm, since 1994. He is vice chairman and co-founder of Empower America, a public interest group. Mr. Weber is also a senior fellow at the University of Minnesota's Humphrey Institute of Public Affairs and co-director of the Institute's Policy Forum. He is also a director of Department 56, Inc. and OneLink Communications, Inc. Mr. Weber has been a Director of ESI since December 1994.

ITT Educational Services, Inc.
Common Stock Market Prices and Dividends

	High	Low
<i>1997</i>		
First Quarter	\$ 27.000	\$ 21.500
Second Quarter	25.000	19.375
Third Quarter	26.750	19.000
Fourth Quarter	26.000	20.750
<i>1998</i>		
First Quarter	\$ 28.375	\$ 21.375
Second Quarter	32.750	24.375
Third Quarter	33.938	26.000
Fourth Quarter	36.125	23.688

The above table reflects the range of market prices of ITT Educational Services, Inc. common stock as reported in the consolidated transaction reporting system of the New York Stock Exchange, Inc.

We did not pay a cash dividend in 1997 or 1998. We do not anticipate paying any cash dividends on our common stock in the foreseeable future and we plan to retain our earnings to finance future growth. The declaration and payment of dividends on our common stock are subject to the discretion of our Board of Directors and compliance with applicable law. Our decision to pay dividends in the future will depend on general business conditions, the effect of such payment on our financial condition and other factors our Board of Directors may in the future consider to be relevant.

There were approximately 200 holders of record of our common stock on February 11, 1999.

ITT Educational Services, Inc. common stock is listed on the New York Stock Exchange, Inc., under the trading symbol "ESI."

Shareholder questions can be answered by contacting ESI's transfer agent:

THE BANK OF NEW YORK 1-800-254-2823

Address Shareholder Inquiries To:

Shareholder Relations Department-11E
P.O. Box 11258
Church Street Station
New York, NY 10286

Send Certificates For Transfer and Address Changes To:

Receive and Deliver Department-11W
P.O. Box 11002
Church Street Station
New York, NY 10286

E-Mail Address:

Shareowner-svcs@Email.bankofny.com

Internet Address:

http://stock.bankofny.com

Transfer Agent and Registrar for Common Stock

The Bank of New York
101 Barclay Street
New York, NY 10286

ITT TECHNICAL INSTITUTES

ALABAMA	500 Riverhills Business Park, Birmingham 35242	(205) 991-5410	NEVADA	168 Gibson Rd., Henderson 89014 (Las Vegas)	(702) 558-5404
ARIZONA	4837 E. McDowell Rd., Phoenix 85008	(602) 252-2331	NEW MEXICO	5100 Masthead St., N.E., Albuquerque 87109	(505) 828-1114
	1840 E. Benson Highway, Tucson 85714	(520) 294-2944	NEW YORK	13 Airline Dr., Albany 12205	(518) 452-9300
ARKANSAS	4520 S. University Ave., Little Rock 72204	(501) 565-5550		2295 Millersport Highway, Getzville 14068 (Buffalo)	(716) 689-2200
CALIFORNIA	525 N. Muller Ave., Anaheim 92801 (L. A.)	(714) 535-3700		235 Greenfield Pkwy., Liverpool 13088 (Syracuse)*	(315) 461-8000
	3979 Trust Way, Hayward 94545 (San Francisco)	(510) 785-8522	OHIO	3325 Stop Eight Rd., Dayton 45414	(937) 454-2267
	16916 S. Harlan Rd., Lathrop 95330 (Stockton)	(209) 858-0077		4750 Wesley Avenue, Norwood 45212 (Cincinnati)	(513) 531-8300
	2051 Solar Dr., Oxnard 93030 (L. A.)	(805) 988-0143		14955 Sprague Rd., Strongsville 44136 (Cleveland)	(440) 234-9091
	10863 Gold Center Dr., Rancho Cordova 95670 (Sacramento)	(916) 851-3900		1030 N. Meridian Rd., Youngstown 44509	(330) 270-1600
	630 E. Brier Dr., San Bernardino 92408 (L. A.)	(909) 889-3800	OREGON	6035 N.E. 78th Court, Portland 97218	(503) 255-6500
	9680 Granite Ridge Dr., San Diego 92123	(619) 571-8500	PENNSYLVANIA	5020 Louise Dr., Mechanicsburg 17055 (Harrisburg)	(717) 691-9263
	5104 Old Ironsides Dr., Santa Clara 95054 (San Fran)	(408) 496-0655		105 Mall Blvd., Monroeville 15146 (Pittsburgh)	(412) 856-5920
	12669 Encinitas Ave., Sylmar 91342 (L. A.)	(818) 364-5151		Eight Parkway Center, Pittsburgh 15220	(412) 937-9150
	20050 S. Vermont Ave., Torrance 90502 (L.A.)	(310) 380-1555	SOUTH CAROLINA	One Marcus Dr. Bldg. 4, Greenville 29615	(864) 288-0777
	1530 W. Cameron Ave., West Covina 91790 (L. A.)	(626) 960-8681	TENNESSEE	10208 Technology Dr., Knoxville 37932	(423) 671-2800
COLORADO	500 East 84th Avenue, Thornton 80229 (Denver)	(303) 288-4488		1255 Lynnfield Rd., Memphis 38119	(901) 762-0556
FLORIDA	3401 S. University Dr., Fort Lauderdale 33328	(954) 476-9300		441 Donelson Pike, Nashville 37214	(615) 889-8700
	6600-10 Youngerman Circle, Jacksonville 32244	(904) 573-9100	TEXAS	551 Ryan Plaza Dr., Arlington 76017 (Dallas)	(817) 794-5100
	2600 Lake Lucien Dr., Maitland 32751 (Orlando)	(407) 660-2900		6330 Highway 290 East, Austin 78723	(512) 467-6800
	7955 N.W. 12th Street, Miami 33126	(305) 477-3080		1640 Eastgate Dr., Garland 75041 (Dallas)	(972) 279-0500
	4809 Memorial Highway, Tampa 33634	(813) 885-2244		2222 Bay Area Blvd., Houston 77058 (South)	(281) 486-2630
IDAHO	12302 W. Explorer Dr., Boise 83713	(208) 322-8844		15621 Blue Ash Dr., Houston 77090 (North)	(281) 873-0512
ILLINOIS	7040 High Grove Blvd., Burr Ridge 60521 (Chicago)	(630) 455-6470		2950 S. Gessner, Houston 77063 (West)	(713) 952-2294
	375 W. Higgins Rd., Hoffman Estates 60195 (Chicago)	(847) 519-9300		2101 Waterview Pkwy., Richardson 75080 (Dallas)	(972) 690-9100
	600 Holiday Plaza Dr., Matteson 60443 (Chicago)	(708) 747-2571		5700 Northwest Parkway, San Antonio 78249	(210) 694-4612
INDIANA	4919 Coldwater Rd., Fort Wayne 46825	(219) 484-4107	UTAH	920 W. LeVoy Dr., Murray 84123 (Salt Lake City)	(801) 263-3313
	9511 Angola Court, Indianapolis 46268	(317) 875-8640	VIRGINIA	863 Glenrock Rd., Norfolk 23502	(757) 466-1260
	10999 Stahl Rd., Newburgh 47630 (Evansville)	(812) 858-1600		300 Gateway Centre Pkwy., Richmond 23235*	(804) 330-4992
KENTUCKY	10509 Timberwood Circle, Louisville 40223	(502) 327-7424	WASHINGTON	2525 223rd St. S.E., Bothell 98021 (Seattle)	(425) 485-0303
LOUISIANA	140 James Dr. East, St. Rose 70087 (New Orleans)**	(504) 463-0338		12720 Gateway Dr., Seattle 98168	(206) 244-3300
MASSACHUSETTS	1671 Worcester Rd., Framingham 01702 (Boston)	(508) 879-6266		1050 N. Argonne Rd., Spokane 99212	(509) 926-2900
	10 Forbes Rd., Woburn 01801**		WISCONSIN	6300 W. Layton Ave., Greenfield 53220 (Milwaukee)	(414) 282-9494
MICHIGAN	4020 Sparks Dr. S.E., Grand Rapids 49546	(616) 956-1060	ESI National Headquarters	5975 Castle Creek Parkway North Drive	
	1522 E. Big Beaver Rd., Troy 48083 (Detroit)	(248) 524-1800		P.O. Box 50466	
MISSOURI	1930 Meyer Drury Dr., Arnold 63010 (St. Louis)	(314) 464-6600		Indianapolis, IN 46250-0466	(317) 594-9499
	13505 Lakefront Dr., Earth City 63045 (St. Louis)	(314) 298-7800			
NEBRASKA	9814 M St., Omaha 68127	(402) 331-2900			

* Opened in January 1999 ** Scheduled to open in 1999

Wired

Inspired

Hired

The mission of ITT Educational Services, Inc. is to provide a quality postsecondary education and the services that can help a diverse student body begin to prepare for career opportunities in various fields involving technology.

We will strive to establish an environment for students and employees which promotes professional growth, encourages each person to achieve his or her highest potential and fosters ethical responsibility and individual creativity within a framework of equal opportunity.