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LOPE - Q1 2017 Grand Canyon Education Inc Earnings Call

EVENT DATE/TIME: MAY 04, 2017 / 8:30PM GMT

THOMSON REUTERS

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Grand Canyon Education First Quarter 2017 Conference Call. (Operator Instructions) As a reminder, this conference call is being recorded.

I would now like to introduce your host for today's conference, Mr. Brian Roberts, General Counsel. Sir, you may begin.

Brian M. Roberts - *Grand Canyon Education, Inc. - SVP, General Counsel and Company Secretary*

Thank you. Speaking on today's call is our Chairman, President and CEO, Brian Mueller; and our CFO, Dan Bachus.

Please note that many of our comments today will contain forward-looking statements that involve risks and uncertainties. Various factors could cause our actual results to be materially different from any future results expressed or implied by such statements. These factors are discussed in our SEC filings, including our annual report on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K. We undertake no obligation to provide update with regard to the forward-looking statements made during the call, and we recommend that all investors review these reports thoroughly before taking a financial position in Grand Canyon.

And with that, I will turn the call over to Brian.

Brian E. Mueller - *Grand Canyon Education, Inc. - Chairman, CEO, President and President of Grand Canyon University*

Good afternoon, and thank you for joining Grand Canyon University's First Quarter 2017 Conference Call. In the first quarter of 2017, enrollments grew by 11% and revenues grew by 9.4%. New enrollments grew in the mid-teens year-over-year. Operating margins are 30.9%. We had another great quarter. I, again, want to thank all faculty staff for their hard work and the incredible results they continue to produce.

As many of you know, our long-term goals are to grow the universities enrollments by 6 to 8 percentage points per year, grow revenues by 8 to 9 percentage points per year and grow margins by 20 basis points on an annual basis without raising tuition.

The enrollment growth is a combination of online enrollments growing 6% to 7% and our traditional campus enrollments growing by 8% to 10%. Revenue growth will happen as a result of continued increases in retention levels and ground enrollments becoming a larger percentage of total enrollment. Revenue, typically, exceeds enrollment growth. This quarter, it did not, due to a shift in the start dates for the spring semester for ground traditional students.

This past weekend, we finished the traditional academic year with 6 graduations in our arena attended by approximately 30,000 graduates, family members and friends. What is becoming so obvious is that the student stereotypes that pundits apply to not-for-profit and for-profit universities are gross over simplifications. There is a wide spectrum of institutions in the for-profit sector, even as there is a wide spectrum of institutions in a not-for-profit sector. Institutional comparison should be made according to their programmatic and student types, and not with respect to their tax status.

We had 17,400 students on campus this year and that number will grow to over 19,000 next year. Average incoming GPAs of the approximately 7,000 new students next year will be about 3.5. Our Honors College will grow to 1,500 students and their average incoming GPAs will be over 4.1.

Grand Canyon University continues to look more like a traditional university than many not-for-profit traditional universities. For example, many universities are struggling to provide robust co-curricular activities for students. These activities have been a huge part of a college student's education for decades. Our economic model allows us to continue to expand that part of the students' experience, and is becoming one of the reasons students are selecting GCU.

In the year we just completed, we had approximately 1,000 students participating in music, theater, dance and digital film. Our parliamentary debate team finished ranked 14 out of 159 teams nationally. And our team is the favorite in almost every event they participate in. Our Chapel's attendance was between 5,000 and 7,000 on a weekly basis.

We had 9,000 students involved in Intramurals, and next year we'll have the largest Club Sports program in the country. Our Division 1 athletics program, so far, this year has won 6 conference championships, including baseball, softball, men's golf, men's and women's track and field and the women's tennis. Next year, we will be eligible for NCAA tournament play, and our coaches and athletes are already preparing for a big year.

As I mentioned earlier, for-profit and not-for-profit terminology as a way to categorize universities is outdating, overly simplistic, inaccurate, and in some cases, unfair and harmful to students and graduates. We continue to outpace our new online enrollment growth goals. One major contributing factor is that almost 15% of our new online enrollments came from 90 new programs, certificates and emphasis areas rolled out in the last 2 years. This is an area we will continue to focus on and invest in.

Second, university's brand continues to grow. Working adult students attending the campus in the evening or attending online, told us repeatedly at graduation they chose GCU because they wanted to be a part of a dynamic institution. Retail sales of GCU gear, hotel stays, restaurant sales, season ticket sales, TV viewership and social media participation are all up on an average of 25% this year over the previous year.

Now turning to the results of operations. Net revenues were $248.2 million in the first quarter of 2017, an increase of $21.2 million or 9.4% from $227 million in the prior year period. Operating margin for Quarter 1 2017 was 30.9% in the first quarter compared to 30.3% for the same period in 2016. Net income was $55.9 million for the first quarter of 2017 compared to $43.7 million in the prior year period. After-tax margin was 22.5% compared to 19.2% for the same period in 2016. Instructional cost and services grew from $94.7 million in the first quarter of 2016 to $102.6 million in the first quarter of 2017, an increase of $7.9 million or 8.4%. This increase is primarily due to the increase in the number of faculty and staff to support the increasing number of students attending the university, and an increase in benefit cost between years.

In addition, we continue to see an increase in occupancy cost, including depreciation and amortization and property taxes, as a result of us placing into service additional buildings, especially laboratory intensive STEM buildings to support the growing number of ground traditional students in the fall of 2016. As a percent of revenue, IC&S decreased 40 basis points to 41.3% due to our ability to leverage our growth in instructional cost and services expenses across an increasing revenue base.

Admissions advisory and related expenses as a percentage of revenue decreased to 12.9% from 13%, primarily due to our ability to leverage our admissions advisory personnel across and increasing revenue base. Advertising as a percent of net revenue increased 60 basis points from 9.3% in Quarter 1 2016 to 9.9% in Quarter 1 2017.

With that, I would like to turn over to Dan Bachus, our CFO, to give a little more color at our 2017 first quarter to talk about changes in the income statement, balance sheet and other items as well as to provide updated 2017 guidance.

Daniel E. Bachus - *Grand Canyon Education, Inc. - CFO*

Thanks, Brian. Revenue exceeded our expectations in the first quarter of 2017, primarily due to higher online enrollments as a result of higher-than-expected new enrollments and higher-than-anticipated ancillary revenues.

Revenue per student decreased between years, primarily due to a shift and the timing of our residential traditional campus start dates as the spring semester started 5 days later in 2017 than in 2016. And we have 1 less day of revenue due to 2016 being a leap year. Online revenue per student was down slightly year-over-year, primarily due to the 1 less day of revenue, the timing of the holiday break, mix changes and the fact that we did not raise tuition levels during 2016.

Scholarships as a percent of revenue decreased from 19.1% in Q1 2016 to 18% in Q1 2017, due primarily to a decrease in the traditional scholarship rate year-over-year as a percentage of total revenue and an increase in the ancillary revenues, partially offset by growth in our ground traditional student base. Online scholarships as a percentage of related revenue were up slightly year-over-year.

Bad debt expense as a percentage of revenue improved slightly from 2% in Q1 2016 to 1.8% in Q1 2017. Our effective tax rate for the first quarter of 2017 was 26.5% as compared to 38.0% in the first quarter of 2016. The lower effective tax rate year-over-year is due to our adoption of the share-based compensation standard in the first quarter of 2017, which resulted in the recognition of excess tax benefits from share-based compensation award that vested or settled in 2017 to be recorded in the consolidated income statement. Previously, they were recorded directly to equity.

The inclusion of excess tax benefits and deficiencies that have -- as a component of our income tax expense will increase volatility within our provision for income taxes as the amount of excess tax benefits or deficiencies from share-based compensation award are dependent on our stock price at the date the restricted award vest, our stock price on the date an option is exercised, and the quantity of options exercised. Our restricted stock vests in March each year, so the favorable benefit will primarily impact the first quarter of each year.

This quarter we recorded an excess tax benefit of approximately $8.5 million, which was approximately $5 million higher than we anticipated, resulting in $0.10 of the first quarter EPS beat. This difference is primarily due to a higher stock price and a higher number of options exercised during the quarter than expected.

As I will discuss in a few minutes, we have adjusted some of our assumptions for the rest of the year as a result. We did not repurchase any shares of our common stock for the first quarter of 2017. We have $99.2 million available under our share repurchase authorization as of March 31, 2017.

Turning to the balance sheet and cash flow. Total cash unrestricted and restricted and short-term investments at March 31, 2017, was $240.4 million. Accounts receivable net of the allowance for doubtful accounts is $9 million at March 31, 2017, which represents 3.7 day sales outstanding compared to $7.5 million or 3.4 days sales outstanding at the end of the first quarter of 2016.

CapEx in the first quarter of 2017, excluding our off-site development of $7.9 million was approximately $21.7 million or 8.8% of net revenue. We have commenced construction on an additional dormitory to accommodate the increasing number of ground traditional students. Total CapEx for the year is still estimated to be between $80 million and $100 million, excluding the remaining cost incurred in 2017 related to the new student services center, an apartment garage in close proximity to our traditional ground campus in Phoenix, Arizona. We repaid the $25 million in borrowings on our revolving line of credit in January, and continue to have $150 million available to borrow on our line.

Last, I would like to provide color on guidance we have provided. We have upped our ending enrollment and revenue guidance for each of the remaining 3 quarters of 2017 due to us exceeding our new enrollment expectations in the first quarter of 2017. Our enrollment guidance still assumes high-single, low-teens online new start growth in the second quarter of 2017, and mid-single-digit new start growth in the third and fourth quarter of 2017. We anticipate the deceleration of start growth is due to higher-than-expected growth in new starts that occurred at the end of second quarter of 2016 and continued into the second half of 2016.

Our guidance still assumes a slight increase in retention and an increase in graduates between years of approximately 13% for the year, although we are now projecting an increase of over 20% year-over-year in online graduates in the second quarter. The significant retention gains we have seen in recent years and the continued shift to a high percentage of graduate students continues to result in year-over-year increases in graduate that exceed our total enrollment growth rate.

We estimate our total ground enrollment, which is ground traditional and professional study students to be $5,500 in the summer, $19,000 in the fall and $18,800 at year end. Our expectation for second quarter ground enrollment is down 200 students from previous guidance as the total summer school attendance appears that it will approximate our initial estimate. The number of students scheduled to attend in the first summer school term, which falls in the second quarter, is less than expected.

Our revenue guidance continues to assume no tuition increase for ground campus or online campus. We have slightly increased our full year operating margin, primarily due to higher-than-expected first quarter margin. The margins for the remaining 3 quarters of 2017 have remained generally the same as the flow through of the higher revenue is partially offset by small timing differences and spend. We continue to invest in new program development and various community projects.

We have adjusted our expected effective tax rate for this rest of 2017. The effective tax rate now, not including the effect of new accounting pronouncement, increased slightly to 38.0% due to our higher income tax -- income before taxes. The effective tax rate included the effect of the new accounting pronouncement, have been adjusted down in Q2 to 30.5% and up in Q3 and Q4 to 36.3% and 38.0%, respectively. Again, these are our best estimates at this time and will be impacted by fluctuations in our stock price and differences in the timing of estimated option exercised.

If a contribution in real estate income taxes is made in the third quarter of 2017, we will have the effect of increasing general, administrative expenses and decreasing income tax expense. We have not adjusted our estimates of diluted weighted average shares outstanding. Although we might repurchase additional shares during 2017, these estimates do not assume repurchases.

I will now turn the call over to the moderators so that we can answer questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Jeff Meuler with Robert W. Baird.

Jeffrey P. Meuler - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

In terms of the success that you've had with the new program rollouts, just wondering how much likes that initiative could have? So the programs that you rolled out, thus far, they are driving the growth? Do some of these have some pretty significant scale potential and can continue to grow over the next several years? And then how many meaningful new programs are there still yet to rollout incrementally over the next several years?

Brian E. Mueller - *Grand Canyon Education, Inc. - Chairman, CEO, President and President of Grand Canyon University*

At least our goal is that we will roll out a minimum of 20 on an annual basis. It will probably exceed that. The programs largely are coming out of the existing 9 colleges that we have. If there's any that have a chance to scale to a significant number, it would be in the IT areas. But the rest are -- many of them are in our core areas of education, health care, business. Although, we are growing in our IT programs and -- that would be the one that would have a chance to become one of our larger programs, possibly.

Jeffrey P. Meuler - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

Okay. And then I just want to make sure that I'm hearing you right. It seems from the results and the tone that the demand environment remains good and you're executing well. So there's nothing in terms of the back half guidance assumption of mid-single-digit online new enrollment growth? There's nothing other than the mathematically tougher comp that you're seeing, correct?

Brian E. Mueller - *Grand Canyon Education, Inc. - Chairman, CEO, President and President of Grand Canyon University*

That's it.

Jeffrey P. Meuler - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

Okay. And then just finally, Dan, what was the reason for the slight tweak down in Q4 adjusted EPS guidance?

Daniel E. Bachus - *Grand Canyon Education, Inc. - CFO*

Higher effective tax rate.

Jeffrey P. Meuler - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

Is that related to the stock option or the equity accounting or is it something else?

Daniel E. Bachus - *Grand Canyon Education, Inc. - CFO*

No. It's almost all of that. Because of our higher income, are permanent items are very small and so given the higher income, we saw a slight increase in our expectations of effective tax rate excluding the new accounting pronouncement. So that was 10 or 20 basis points. The rest is all because we believe that we're not going to get nearly as much benefit from stock option exercises in the tail half of the year. It's all been accelerated, we think, where the vast majority will be accelerated into the first half of this year given the higher stock price.

Operator

Our next question comes from the line of Peter Appert with Piper Jaffray.

Peter Perry Appert - *Piper Jaffray Companies, Research Division - MD and Senior Research Analyst*

Brian, I know you've addressed this in the past, but I'm wondering if you've given any root, or further thought, to the issue of just the cosmetics around margin performance. This is a good news/bad news, right? Your performance is outstanding but it, perhaps, draws attention to you guys. How do you think about that?

Brian E. Mueller - *Grand Canyon Education, Inc. - Chairman, CEO, President and President of Grand Canyon University*

3 or 4 years ago, that was a concern. If you remember, there were people, prior to the great recession commencing in 2008, that were producing huge margins and a lot of them was in the back of annual tuition increases of 6% to 8% annually. We're in a position now where the hybrid campus and the combination of the traditional campus and the online campus is becoming so efficient that our margins have expanded, but they've expanded without raising tuition. And so the value proposition that this continues to represent for students is tremendous. It allows us to continue

to reinvest in higher education infrastructure and new programs, and investors are experiencing positive results as well. So no, it does not. At this point, it doesn't -- that doesn't bother us like it did at one point.

Peter Perry Appert - *Piper Jaffray Companies, Research Division - MD and Senior Research Analyst*

Understood. And then another sort of big picture question. It feels like the competitive dynamic in terms of what you faced in the online market is really shifted, right? The states goes taking a much bigger role in thinking about this Purdue transaction. How do you think that impacts you and -- in particular, this Purdue transaction?

Brian E. Mueller - *Grand Canyon Education, Inc. - Chairman, CEO, President and President of Grand Canyon University*

Well, it's the -- funny you asked that question. The Purdue -- if you look at carefully at the Purdue transaction, it looks very, very similar, if not exact, to the transaction that we proposed a while back. And that transaction was basically approved by the visiting team and then voted down by the board. And so we're going to be watching that carefully and see how that progresses. What we do in the future, we don't know. We would do -- anything that we would do that's related today, would be the best interest of the university and our investors. But it is to our -- we need to keep watching to see how that goes. The reason we've been able to withstand the shift of students going to for-profit schools and going -- and instead going to universities who have now adapted to same delivery models is because, for the most part, students don't see us as a for-profit institution. They see us as a traditional university with a growing dynamic and student body and everything else that goes with that. And so that's been our big advantage. If there is a way down the road for us to have a not-for-profit university and a for-profit service company, and that would be to the benefit of both the university and to our shareholders, we would consider that. We're just going to have to watch it, but we've been able to withstand this thing. In fact, not just withstand it, our brand is getting stronger. And the more people look into who we are, who are students are, our programs and our graduates, the more convinced people become that tax status is irrelevant when considering a university and the benefits that you can get from a university. And that's why I made some of the comments I made earlier because -- and that's an important narrative that has to get out there to offset some of the comments of our detractors.

Brian M. Roberts - *Grand Canyon Education, Inc. - SVP, General Counsel and Company Secretary*

We have reached the end of our first quarter conference call. We appreciate your time and interest in Grand Canyon Education. If you still have questions, please contact either myself, Dan Bacchus or Bob Romantic. Thank you very much.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program and you may all disconnect. Everyone, have a wonderful day.
