THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

LOPE - Q2 2017 Grand Canyon Education Inc Earnings Call

EVENT DATE/TIME: AUGUST 01, 2017 / 8:30PM GMT

THOMSON REUTERS

CORPORATE PARTICIPANTS

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

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

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

CONFERENCE CALL PARTICIPANTS

Jeffrey Marc Silber *BMO Capital Markets Equity Research - MD and Senior Equity Analyst*

Nick James Nikitas *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Associate*

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

PRESENTATION

Operator

Good day, ladies and gentlemen, thank you for standing by. Welcome to Q2 2017 Grand Canyon Education Inc. Earnings Conference Call. (Operator Instructions) As a reminder, this conference is being recorded for replay purposes. It is now my pleasure to hand the conference over to 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 calls are 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 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 updates with regards to forward-looking statements made during this call, and we recommend that all investors review these reports thoroughly before taking a financial position in Grand Canyon.

And With that, I'll 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 second quarter 2017 conference call. In the second quarter of 2017, enrollments grew by 10.5% and revenues grew by 14.1%. Excluding the impact of the shift of our residential traditional campus start states, revenue growth would've been 11.7%, which we will explain later. New working adult students attending our online campus grew in the high single-digits year-over-year. Operating margins are at 25.2%. I want to thank our faculty and staff for another great quarter. Working adult students attending our online campus continue to grow at a rate that exceeds our goal of 6% to 7% annually. This has been true now for 4 consecutive quarters. First reason for this has been high single-digit new enrollment growth. The continued growth of the University's brand, 76 new programs certificates and emphasis areas rolled out in the last 24 months, and positive results from new branded advertising campaigns designed 15 months ago have all been contributing factors. Second, the retention rates of online students continue to go up. Graduate students have always had and continue to have high retention rates. These students represent over 50% of our online student body. However, we are now seeing accelerated retention rates of our undergraduate student attending online. About one year ago, we implemented one-on-one tutoring service, utilizing our traditional campus students as tutors. The academic counseling the traditional students provide has positively impacted the nontraditional students as they return to an academic setting. As retention rates continue to climb, we are pleased to report that our estimated 3-year cohort default rate on student loans for the 2015 cohort is on track to decline to just over 6%. We're now just a few weeks from opening the fall semester of the 2017-'18 school year. We expect approximately 6,800 new students. Their average incoming GPAs will be approximately 3.5. 41% will be from Arizona, and 28% will be from California. Colorado, Washington and a number of states from the Midwest are also experiencing significant growth. That will bring our total enrollment on ground to over 19,000 students. Our Honors College will grow to 1,500 students with their average incoming GPAs being 4.1. Approximately 10,500 students will be living in campus residence halls, which will be near capacity. Participation levels on campus will be at an all-time high. Music Theater, dance, intramural sports, clubs sports and clubs related to our 9 colleges continue to grow every year. We will also hit a new high with the number of students participating in career-related internships. This will be our first year of eligibility for NCAA division I tournament play and a number of our teams will compete for post-season spots. We expect our ground campus will continue to grow by about 2,000 students per year. For the 2018-'19 school year, we will add 2 new apartment style residence halls, a major classroom facility, a club sports facility and a parking garage. Revenue continues to exceed our goals because ground students, as a percentage of the overall student body, continues to grow. Average revenue per student is higher on ground due to room and board payments. This is important because we intend to continue to meet or exceed our revenue goal without raising tuition for either ground or online students. Plans are in place to make an even larger impact on the community that we live in this school year. We'll continue to focus on bringing new employment opportunities to the neighborhood, both on our campus and in the new small businesses we're building. We renewed our 5-year agreement with the City of Phoenix, Police by committing new resources to drive crime out of the area. Our goal is to raise $2.7 million to the state tax credit program to continue our work with Habitat for Humanity. Our objective is to renovate 800 homes in a 5-year time frame. We currently have 150 homes completed and housing values are up in our neighborhood 30%. When school begins in the fall, will have 1,500 GCU students, providing one-on-one tutoring and mentoring to 65 K-12 schools on the west side of Phoenix. The goal is to transform an intercity community and make it a middle-class, highly desirable place to live.

Now turning to the results of operations. Net revenues were $218.3 million in the second quarter of 2017, an increase of $27 million or 14.1% from the $191.3 million in the prior year period. Operating margin for quarter 2 2017 was 25.2% in the second quarter compared to 23.4% for the same period in 2016. Net income was $39.8 million for the second quarter of 2017, compared to $27.6 million in the prior year period. After-tax margin was 18.3% compared to 14.4% for the same period of 2016. Instructional cost and services grew from $84.6 million in the second quarter of 2016 to $95 million in the second quarter of 2017, an increase of $10.4 million or 12.3%. 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. In addition, we continue to see an increase in occupancy cost, including depreciation and amortization in 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. As a percent of revenue, IC&S increased 70 basis points to 43.5%, primarily due to a decrease in employee compensation and related expenses and other instructional cost and services as a percentage of revenue, partially offset by the increase in depreciation and occupancy expense. It's important to note that salaries at the university continues to increase, but the technology and automation has allowed revenue increases to outstrip employee costs. Admissions advisory and related expenses as a percentage of revenue decreased 90 basis points to 14.2% from 15.1%, primarily due to our ability to leverage our admissions advisory personnel across the increasing revenue base. Advertising expense as a percent of net revenue decreased 30 basis points from 11.6% in Q2 2016 to 11.3% in Q2 2017.

With that, I'd like to turn it over to Dan Bachus, our CFO, to give a little more color on 2017 second quarter, 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 second quarter of 2017 primarily due to higher online enrollment as a result of higher-than-expected new enrollments and better-than-expected retention. We also recognized a higher-than-anticipated traditional campus summer school revenue and ancillary revenues. Revenue per student increased between years, primarily due to our residential traditional student body growing faster than our working adult student body. When factoring in room, board and fees, the revenue per student is higher for residential students than our other students. In addition, we saw a favorable shift in the timing of our residential traditional campus start dates as the spring semester ended later in 2017 than in 2016, giving us 6 additional days of traditional campus revenue in 2017, compared to 2016. Online revenue per student was up slightly year-over-year, primarily due to the fewer students taking summer breaks compared to 2016. Scholarships as a percentage of revenue increased from 14.2% in Q2 2016 to 14.5% in Q2 2017, due primarily to a slight increase in an online scholarships year-over-year. Bad debt expense as a percentage of revenue improved from 1.8% in Q2 2016 to 1.6% in Q2 2017. Our effective tax rate for the second quarter of 2017 was 28% as compared to 38.4% in the second 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 was 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 as a component of our income tax expense, will increase volatility within our provision for income taxes as amount of excess tax benefits or deficiencies from share-based competition awards are dependent on our stock price at the date the restricted awards 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 have the greatest impact in the first quarter each year.

This quarter, we recorded an access tax benefit of approximately $5.3 million, which was approximately $1.6 million higher than we anticipated, resulting in $0.03 of the second quarter EPSB. We did not repurchase any shares of our common stock in the second quarter of 2017. We have $99.2 million available under our share repurchase authorization as of June 30, 2017.

Turning to the balance sheet and cash flows, total cash unrestricted and restricted in short-term investments at June 30, 2017, was $235.1 million. Accounts receivable net of allowance for doubtful accounts is $10.9 million at June 30, 2017, which represents 4.1 days sales outstanding compared to $9.1 million or 4.0 days sales outstanding at the end of the second quarter 2016.

CapEx from the second quarter 2017, excluding our offsite development of $1.5 million, was approximately $28.8 million or 13.2% of net revenue. The campus projects for the 2017-'18 school year are on schedule and on budget. Total CapEx for the year is estimated to be between $80 million and $100 million, excluding the offsite development and additional land purchases that have been or might still be made adjacent to the campus. We continue to have $150 million available to borrow on our line.

Last, I'd like to provide color on guidance we have provided for 2017. We have upped our ending enrollment and revenue guidance for the second half of 2017, due to us exceeding our enrollment expectations in the first half of 2017. We have also upped our third quarter revenue guidance due to higher-than-expected traditional campus summer school enrollment, which is not reflected in the third quarter enrollment amount.

Our enrollment guidance still assumes a mid-single-digit new start growth in the third and fourth quarter of 2017. The anticipated deceleration of start growth is due to the higher-than-expected growth in new start that occurred at the end of the second quarter of 2016 and continued into the second half of 2016.

Our guidance still assumes a slight increase in retention and increase in graduates between years of approximately 13% for the year. The significant retention gains, which we have seen in recent years and a continued shift to a higher percentage of graduate students continues to result in year-over-year increase in graduate that exceed our total enrollment growth rate. We continue to estimate our total ground enrollment ground traditional and professional study students to be 19,000 in the fall and 18,800 at year end.

Our revenue guidance continues to assume no tuition increase for our ground campus or our online campus. The margin for the third quarter has been raised 50 basis points, excluding the $2 million contribution in lieu of state income taxes made in July of 2017, which has the effect of lowering margins by 90 basis points in the third quarter. As you might recall, these statements have the effect of increasing general and administrative expenses in the third quarter of each year, and these payments reduce dollar for dollar, our state income taxes. Three quarters of the lower tax rate is reflected in the third quarter as we true-up our annual effective tax rate and remaining is reflected in a lower tax rate in the fourth quarter. We have lowered the margin slightly in the fourth quarter as we plan to reinvest greater than originally planned. We continue to invest in new program development and various community projects. Our effective tax rate of 33.9% in Q3 and 37.4% in Q4 are our best estimates at this time. The lower rate includes the effect of a contribution in state lieu income taxes, and taxes will be further impacted by fluctuations in our stock price and differences in the timing of estimated option exercise. Although, we might repurchase additional shares during 2017, these estimates do not assume repurchases.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question will come from the line of Peter Appert with Piper Jaffray.

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

So the numbers continue to be impressive. Brian, can you give us more color in terms of, maybe, programmatics areas where you're seeing particular enrollment strength?

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

Yes. we continue to invest in IT programs at the [baccalaureate] level especially. We continue to invest in programs that are in education areas like autism, which is a fast growing area in need -- in public school systems throughout the country. And we continue to invest in counseling programs both at the undergraduate and graduate level. Addition, counseling, and areas like that are fast-growing occupation areas and there's a lot of need for in this in the country, so those programs are growing too.

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

So those 3 that you called out IT, specialized education, counseling. Those are incrementally the things that are driving the accelerated growth?

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

Yes. And then there's a lot of offshoots in our other programs. Data analytics is really a fast growing program in our -- that comes out of our business programs. Sports business is growing at an accelerated rate because of the Colenso School and that brand. And then, of course, on the ground, we've got 7 engineering programs that are growing that will -- in fact, we'll be entering a third year of our first -- our students. And so next year, we'll have our first graduates in electrical, mechanical, biometric engineering. And there are 4 others in addition to that. So the 97 -- I'm sorry, 79 new programs really are pretty broad-based across all 9 colleges, but if there's one area that's more focused than the other one is IT and technology.

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

Got it. And you called out the ground enrollment in terms of 41% Arizona and 28% California, can you talk about how that's evolve overtime?

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

Yes. A number of years ago we were in the mid-50s in terms of Arizona and probably in the mid-to-high teens in California. And so as the base of students in Arizona has just gotten bigger, their percentage increase has gone down some. California just continues to be a huge area for us as well as Colorado, Washington and Oregon. And then, like as we said last time, there are faith in the Midwest that are now really starting to grow. People have caught out to our low tuition rates and so that word is spreading. So we continue to grow, we're growing accelerated rate in the Midwest.

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

Great. And then, you addressed this I think, some extent of the call, but just the sequential slower growth rate in online starts beyond the comp. Is there anything you'd call out about that?

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

No. That's strictly a year ago, just a little bit under -- a little bit over a year ago at this time, things just really started to pick up. Our brand is getting very strong in the Southwest and the number of working adults students who want to attend online and not just online, but the number working adults students who want to come to campus in the evening and be a part of all this, that really was one of the catalyst that got this thing started. So going into the third and fourth quarter, we're going to have -- our enrollment growth is going to continue. It's just the comp is a little bit different.

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

Understood. And then last thing for me. Dan, can you talk about any preliminary thoughts around CapEx spending in '18?

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

Yes. It's going to be higher than '17. This year, we built one dorm. We're going to build 2 dorms. We did not build a parking garage or a classroom building. We're going to do both of those. So as -- we still feel very good about our $100 million on average over the 5-year period with '17 being a little bit under that $100 million and '18 will be a little bit above that. The only thing that would cause those numbers to change a little bit and we're seeing a little bit in '17 is whether we're able to buy property adjacent to the campus. There's property available and we'll pay a reasonable amount for it. But we're not going to be held hostage for it. So if there is reasonable buys out there, we'll buy. If there isn't, we don't need to, and so we won't.

Operator

Our next question will come from Jeff Meuler with Robert W. Baird.

Nick James Nikitas - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Associate*

Nick Nikitas on for Jeff. Dan, you mentioned the change in ground start dates year-over-year, but relative to the guidance you guys gave, was there any stable little variance or was that already incorporated?

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

It was already incorporated in the guidance we gave. The higher revenues in our guidance was really driven by the things I talked about on the call, the higher online enrollments over the entire quarter. And then it's higher summer school enrollments that don't -- that aren't necessarily reflected in the enrollment numbers we give, because by the time the end of the third quarter happens, we have our fall enrollment number in there. So we are generating more revenue than we expected on the ground campus this summer and a much more revenue than we expected from our online campus.

Nick James Nikitas - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Associate*

Okay, perfect, just want to make sure on that. And then Brian, apologies if I missed this, but I think you said online enrollment was trending above the -- the starts are trending above the long-term range. Did you guys gave a specific number for the starts?

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

We just said high single digits? Yes, so our goal is about 6%, and then with [onground]enrollments, we're trying to get 8%. So high single digits in online enrollment accelerates the growth.

Nick James Nikitas - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Associate*

Okay, and then just on the regulatory front. I think year-round Pell Grants were recently reinstated and there's been some talk of it expanding the G.I. Bill. Do either of those have potential to be needle movers or incremental over the backlog of this year or into '18? Or are they pretty small for you guys?

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

Pretty small. The year-round Pell Grants may impact students' willingness to stay in school through the summer. And so that's -- and that's something we encourage students to do because there are so many part-time jobs here on campus and if they stay here and work and they pick up additional 12 credit hours, many of them can graduate in 3 years, which is huge for them and their families. And then expanded in G.I. Bill I don't think that's going to have a huge impact. So no, I wouldn't say those are going to be catalyst that will cause anything unusual to happen.

Nick James Nikitas - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Associate*

Okay, and then just last one for me. The online persistent rates obviously continue to improve despite being at a really high-level and I think this is the first quarter where you start to talk about the undergrad improvements from some of the academic initiatives you put in place. Just what kind of runway or how early [any instance] of that kind of opportunity and room for growth or continued improvement there?

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

We -- the improvement, really, is with the working adult students, the 32 to 34-year-old students who are coming back to school as an adult, attending our online campus and continuing in their careers and raising their families. That's always been the toughest student, just because life gets in the way, it's hard. But what we've done is we've provided them a lot of academic help in their first 3 classes, which has made the transition a lot more comfortable for them, they've gained confidence. I'd say we're about a year into this where we've started to see the improvements, and how far that can go, we'll see. We're not baking anything into our budget at this time, but it's encouraging to see that group of people be even more successful.

Operator

Our next question will come from the line of Jeff Silber with BMO Capital Market.

Jeffrey Marc Silber - *BMO Capital Markets Equity Research - MD and Senior Equity Analyst*

I always get a lot of questions about the competitive environment and obviously, you folks compete both on at the campus level in the Southwest and then more nationally online. Are you seeing new competitors or are you seeing existing competitors doing anything different than what we've seen of the past few quarters?

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

No. I don't think so. The most interesting phase -- it's a very competitive environment, there's no question about that. I think the way we've differentiate ourselves, obviously, it's the brand of Grand Canyon University and ground campus that's attractive to people. But more important than that, it's the thing I keep emphasizing, which is, you're not going to be successful in this if you're not really watching where the economy is going and making sure that you're building programs to meet specific needs that people have in specific career areas. And so that's been as much of our success as anything. The interesting thing from our standpoint is people are watching the whole thing is going on with Purdue and Kaplan, and they're very interested in us being a service provider. And so there are a lot of people looking into this, but when they -- and a lot of people are doing it, but there's a lot of people who, when they start to understand the significant investment that has to be made in order to do this right and to do it in a high-quality way, they start to think about other ways to make it happen. And so we get a lot of interest from that standpoint, but no, we haven't seen people doing a lot of different things. We just -- it's competitive, and we're doing everything we can to stay out in front of it.

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

Brian, you actually started answering my second question again question before I asked it. In terms of providing those services to some of the other colleges across the country, what would it entail? What kind of infrastructure would you comment have to build? Would there have to be any type of regulatory permission given? Any color you can provide would be great.

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

Yes. I mean, it's -- we've had some pretty high-profile interest -- high-profile institutions expressing interest. The -- who knows what's going to happen. I don't know what's going to happen with the Purdue and Kaplan thing, we're just watching it. And so we'll see where that goes. We have an interest in doing it possibly, because we wouldn't have to add a lot of infrastructure. We put hundreds of millions of dollars into building out this infrastructure and both from a learning standpoint, from a curriculum standpoint, instruction, the ability to assess learning. But then also all front-end -- all the back end stuff, the admissions processing and the transcript evaluation and the financial aid advising and all of that is all automated. And so we wouldn't have to add very much in terms of technology infrastructure and we wouldn't even have to add that much in terms of personnel in order to do this on a limited basis and I think it would be a service that would, especially, allow certain private universities to stay in business and prosper. And so it would a interesting thing for us to do. We feel like we're equipped and could do with well without investing a lot. But we'll just see, we'll see how the next 6 months ago. We're just watching it carefully.

Jeffrey Marc Silber - *BMO Capital Markets Equity Research - MD and Senior Equity Analyst*

Okay, great. And then just one question for Dan. You mentioned the change in the timing of a semester. Anything else we need to be aware of going forward over the next few quarters when we're comparing on a year-over-year basis?

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

Yes. There's a little bit of a difference between in the fall semester, it's about a 1 day difference. One day of additional revenue in the third quarter, and one less day in the fourth quarter, but that's -- I think the number is about $1 million. I gave it our estimate to that, at the original guidance call and you can go back and look at that. So there is a little bit of impact between the third and fourth in comparison to the prior year, but it's much smaller than what we saw between the first and the second this year.

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

We've now reached the end of our second quarter conference call. We appreciate this time, and interest in Grand Canyon Education. If you still have questions, please contact either myself, Dan Bachus or Bob Romantic. Thank you very much.

Operator

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