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PRESENTATION

Operator

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

I would now like to turn the call over to Brian Roberts, General Counsel. 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 updates with regard 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 Third Quarter 2017 Conference Call. In the third quarter of 2017, enrollments grew by 10.7% and revenues grew by 12.2%. New working adult students attending our online campus grew in the high single digits year-over-year. Operating margins are at 25.3%. I want to thank our faculty and staff for another great quarter.

As you know, our long-term goals are to grow enrollment 7% to 8% on an annual basis, 6% to 7% will come from online enrollments and the rest from our ground campus. Revenues will grow 8% to 9% without tuition increases, primarily as a result of continued retention increases, traditional campus enrollment becoming a higher percentage of the total and the growth of ancillary revenues through new businesses.

The room and board payments of our ground students continue to drive up annual revenue per student number. Operating margins will expand by 20 to 30 basis points per year. Driving the brand of university through the vibrancy and accomplishments of the traditional campus will continue to be a priority. We now have 9 colleges, over 220 programs, emphases and certificates and plan to grow the offerings by a minimum of 20 per year.

The quality of student body continues to grow. This year, freshmen class has an incoming GPA of 3.5 -- average incoming GPA of 3.5 and Honors College is now at 1,600 students with an average incoming GPA of 4.1.

The highest academic growth areas are in STEM-related fields in our business programs. Many universities are cutting back in the performance areas while we continue to invest in them. Music, theater, dance, debate, athletics and club sports are great educational experiences for students and a positive way to lift the brand of the institution. To support this growth, this coming year will be a big building year as we will add a major classroom building, 2 residence halls, a club sports facility and a new parking garage. We will also pick up additional property as we expand to 400 acres to eventually accommodate approximately 30,000 students. We are also continuing to invest in 140,000 square-foot innovation center. We've built a cybersecurity warfare range in that center, but are contemplating and investing in additional cybersecurity education options, additive and advanced manufacturing offerings and expanded computer science offerings, including coding. We anticipate giving you more color on these initiatives in the first half of next year.

The focus of our online campus continues to be programmatic expansion, growing the graduate student number and continuing to increase the support services offered to students. We've exceeded our online enrollment numbers primarily because of new program growth. 14% of our new online students have come from programs rolled out in the last 2 years. 57% of the students studying in the new programs are graduate students. We continue to invest in full-time faculty, counseling services, library services, one-on-one academic support, online classroom enhancements and research around online education pedagogy.

Over the most recent 2-year time period, our faculty have written 65 scholarly articles and presented at 106 conferences all related to increasing the effectiveness of online teaching and learning.

Being recognized as the thought leader in this area is an important part of our plan going forward. Our work in the community continues. In the last 18 months, we've opened 2 restaurants, a hotel, an office complex, a golf course, a coffee company, an advertising company and a promotions company. These businesses are all adding jobs in the community. We've renewed our client's pricing initiatives with the city of Phoenix. We'll renovate approximately 100 homes this year through our Habitat for Humanity partnership, with the goal of 800 within the next 5 years, and expand K-12 tutoring and mentoring efforts to 75 schools in the local area.

Now turning to the results of operations. Net revenues were $236.2 million in the third quarter of 2017, an increase of $25.8 million or 12.2% from the $210.4 million in the prior year period.

Operating margin for Q3 2017 was 25.3% in the third quarter compared to 22.4% for the same period in 2016. Net income was $39.3 million for the third quarter of 2017, compared to $29.2 million in the prior-year period. After-tax margin was 16.6% compared to 13.9% for the same period in 2016.

Instructional costs and services grew from $91.7 million in the third quarter of 2016 to $104.3 million in the third quarter of 2017, an increase of $12.6 million or 13.7%. This increase is primarily due to the increased number of faculty and staff to support the increasing number of students attending the university. Also, we incurred an increase in benefit cost between years. In addition, we continue to see an increase in occupancy cost including depreciation, amortization and occupancy cost as a result of us placing into service additional buildings, especially laboratory-intensive STEM buildings to support the growing number of ground traditional students.

During the third quarter of 2017, we wrote off the remaining book value of 2 buildings that will be replaced by a new classroom building that is needed for the fall of 2018.

As percent of revenue, IC&S increased 60 basis points to 44.2%, primarily due to an increase in depreciation, amortization and occupancy cost, including disposals as a percentage of revenue over the prior year, as well as an increase in employee compensation and related expenses over the prior year, primarily due to staffing for the growth in the ground traditional enrollment.

Admissions advisory and related expenses as a percentage of revenue decreased 40 basis points to 13.3% from 13.7% primarily due to our ability to leverage our admissions advisory personnel across an increasing revenue base. Advertising expense as a percentage of net revenue decreased 60 basis points from 11.4% in Q3 2016, to 10.8% in Q3 2017.

With that , I would like to turn it over to Dan Bachus, our CFO, to give a little more color on our 2017 third 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 third quarter of 2017 primarily due to the reasons Brian cited earlier. Revenue per student also increased between years primarily due to 1 additional day of traditional campus revenue in the fall semester of 2017 as compared to 2016, with 6 additional days of revenue from our summer term in 2017 as compared to 2016 due to favorable shifts in the timing of our residential traditional campus start date.

Online revenue per student was up slightly year-over-year. Scholarships as a percentage of revenue increased from 15.2% in the third quarter of 2016 to 15.7% in the third quarter of 2017, due primarily to a slight increase in online scholarships year-over-year and the growth in ground traditional students. Although, ground scholarships as a percentage of the related revenue are down year-over-year, there are more ground students and their scholarship rate is much higher than the online students.

Bad debt expense as a percentage of revenue stayed flat at 2.3% for the third quarter of 2017 compared to the third quarter of 2016. Our effective tax rate for the third quarter of 2017 was 35.1% compared to 34.2% in the third quarter of 2016. The effective tax rates for both quarters were lower than our annual effective tax rates, due to the contributions made in lieu of state income taxes to school sponsoring organizations. Our contribution decreased from $4 million in Q3 2016, to $2 million in Q3 2017. As you might recall, these payments 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. 3/4 of the lower tax rate is reflected in the third quarter as we true up our annual effective tax rate and the remaining is reflected in a lower tax rate in the fourth quarter.

The decrease in contributions over the prior year was offset by the 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 reported in the consolidated income statement. Previously they were recorded directly to equity. Our effective tax rate of 35.1% for the third quarter was higher than the rate we projected at 33.9%, primarily due to the higher income before taxes, which lowered the impact of our discrete tax items.

We did not purchase any shares of our common stock in the third quarter 2017, but did purchase 10,000 shares subsequent to the end of the third quarter at a cost of approximately $850,000. We had $99.2 million available under our share repurchase authorization as of September 30, 2017. Our Board of Directors has extended the expiration date for our share repurchase program to December 31, 2018.

Turning to the balance sheet and cash flows, total cash unrestricted and restricted and short-term investments at September 30, 2017, was $345.4 million. Accounts receivable net of the allowance for doubtful accounts is $12.2 million at September 30, 2017, which represents 4.8 days sales outstanding compared to $10.4 million or 4.5 days sales outstanding at the end of the third quarter in 2016.

CapEx in the third quarter 2017, excluding our offsite development of $0.8 million, was approximately $25.1 million or 10.6% of net revenue. Campus projects for the 2017/2018 school year completed on or under budget. Total CapEx for the year is still 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 the fourth quarter of 2017. We have upped our ending enrollment and revenue guidance for the fourth quarter of 2017 due to us exceeding our online enrollment expectations at the end of the third quarter and due to higher projected ancillary revenues. Our enrollment guidance still assumes mid-single digit new start growth in the fourth quarter of 2017. Our guidance also still assumes a slight increase in retention and an increase in graduates between years. The significant retention gains we've seen in recent years and a continued shift to a higher percentage of graduate students continues to result in year-over-year increases in graduates that exceed our total enrollment growth rate.

We continue to estimate our total ground enrollment, ground traditional and professional studies students to be 18,800 at year end. Our revenue guidance continues to assume no tuition increase for our ground campus or our online campus, and continues to reflect a $1.1 million decrease compared to the prior year for the one day shift in the start date of ground traditional campus. The estimated margin for the fourth quarter is consistent with what we have previously provided as expenses are tracking in line with the expectations. We continue to invest in new program development and various community projects. Our effective tax rate of 37.4% in Q4 continues to be our best estimate at this time. The lower rate includes the effective contribution in lieu of state income taxes and share-based compensation and thus will be impacted by fluctuations in our stock price and differences in the timing of estimated option exercises.

Although, we might repurchase additional shares during 2017, these estimates do not assume repurchases.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Peter Appert of Piper Jaffray.

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

The strength, Brian, in online starts is pretty impressive, particularly, against these tough comps you're facing. And I'm wondering if it gives you any reason to rethink your longer-term expectations in terms of growth, that's part one. And then part two is, just any more color you can provide in terms of the drivers of the online strength in particular?

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

No, we're still -- we are ahead of what we've been telling people, but we do expect this to slow down next quarter. And so we've been saying for a number of quarters now that the comps do get tougher. We did exceed our expectations to some extent in this quarter, but we do expect that to slow down in the next couple of quarters and be more -- meet more in terms of what our long-term guidance has been. The drivers are the building of the brand. The brand is very strong and it resonates to our surprise, throughout the country. For a while we were talking about this being mainly a southwest play, but our brand is getting very strong in other parts of the country and people recognize the name and -- so that's one part of it. The advertising strategies have been very effective and they've communicated our message very efficiently. And -- but I think still, the most important thing is the students that we're getting from the new programs. I have been saying for a while that the most important part of strategy for this business is to understand where the economy is going, where the jobs are going to be, and develop programs that will help people gain those jobs and we're trying very hard to do that. And I think that's the biggest reason we're exceeding our goals in the short run, but the numbers [are] getting big, so we're trying to caution people about that.

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

Got it, okay. The 10,000 shares repurchased, it's like almost a teaser, I think, in terms of not even toe in the water. Thought process in terms of maybe stepping up the share repurchase plan?

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

Well, some of you will probably ask this question later anyway, so we'll just answer it now. We -- obviously, what's going on at Purdue and with Kaplan, people are asking the question about whether we would go back and consider that. And the answer is, yes, we have not made a decision to do that, but consider it, yes we would. And so in case we would decide to more aggressively pursue a not-for-profit status, and a for-profit public traded service company, which we think we would be well positioned to execute on, if we decided, we want our cash balance to be as large as possible. And so you can expect us to be more aggressive as that cash builds up. But we have some big decisions to make in the next number of months and we want that cash amount to be as high as possible.

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

Understood. And then just on that for a second, Brian, can you expand on sort of what the decision criteria are? What you need to see to move forward, what the structure could potentially look like?

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

It's the rules. They're going to establish rules in November. And so the criteria...

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

The Higher Learning Commission will [be]...

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

Yes. The Higher Learning Commission is going to do that, and we want to see what those rules are, what that language is. And if that makes sense for us, then we would possibly move forward. But we need to wait until that comes out.

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

Got it. And then one last thing for Dan. In terms of preliminary thoughts on CapEx for next year. It sounded like, perhaps, the building program steps up again. Is that correct or not?

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

It's consistent with what we've been saying. We want to average about $100 million a year, excluding the potentially land purchases. This year will be a little bit below the $100 million. Next year, we expect it to be a little bit above the $100 million, as high as maybe $120 million next year. And so -- but over the 5-year period, as we've been saying, we continue to believe that we'll average about $100 million.

Operator

Our next question comes from Jeff Silber of BMO Capital Markets.

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

Just going back to the online growth, and forgive me, I think you just spoke a little bit too quickly for my pen. Can you just give us a bit more color, was it spending more, I mean, you mentioned the strength of the brand, but I'm just curious if there were any changes in the rate of the spend that you did?

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

No, we're spending what we've anticipated spending. We're within budget with regards to the advertising budget. It's just the messaging is becoming more effective. It's becoming much more efficient and we generate far fewer leads and convert them at a much higher rate. And so we attribute that to the efficiency and effectiveness of the messaging, but also the strength of the brand.

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

Okay, great. And I know everybody asked this quarter so it'll be my turn this time. From a competitive perspective, I know it's, obviously, a competitive media. Any change over the past few months? Any new competitors coming in, going out, et cetera?

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

Not really, and we talk to our people every 2 weeks in a major meeting. And no, we have not noticed any significant difference in the last couple of months.

Operator

Our next question comes from Alex Paris of Barrington Research.

Christopher Huang Howe - *Barrington Research Associates, Inc., Research Division - Research Analyst*

This is Chris Howe sitting in for Alex Paris. Just in relation to some of the previous comments that were made by Peter. Could you, perhaps, provide some general commentary on some of the improvements to this advertising strategy? And as I was thinking about some of your competitors and how they did it in the past, do you use third-party lead generation?

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

So that's the big change. We've been able to move away from that to a large extent. And that's a major shift. We're getting high-quality messaging out there with television campaigns, social media campaigns, and that messaging builds the brand, drives a lot higher quality of person who's interested in your program. We need fewer of those people to be interested and we put them into class at a higher rate. So -- and that's been going on for a couple of years now.

Christopher Huang Howe - *Barrington Research Associates, Inc., Research Division - Research Analyst*

Okay. And then you had commented about CapEx expectation for this year and also next, would you be able to provide any commentary on depreciation and amortization and/or stock compensation expense?

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

Yes, sure. So we have seen a pretty significant year-over-year increase in depreciation and amortization as a percentage of revenue this year and the year before because of the huge CapEx buildings in the years prior to that. Given that this year is -- has ticked down, we expect depreciation and amortization maybe to be up 10 or 20 basis points year-over-year. Next year could be flat to up 10 to 20 basis points. So that will be slowing on a year-over-year basis as a percentage of revenue as will stock-based comps. So stock-based comps could be up. It could be flat, but as much as 10 or 20 basis points up year-over-year. But you won't see big year-over-year increases in those amounts as a percentage of revenue going forward.

Christopher Huang Howe - *Barrington Research Associates, Inc., Research Division - Research Analyst*

Okay. And then one last question, if I may. You had previously made some comments about the success in the acceleration in enrollments that you're seeing from the Midwest and from states like California. Has the message started to resonate even further outside of these success areas, perhaps, into new hidden gems within geography?

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

Yes. Really, on both sides of it. We were moving in a direction of being a more Southwest play for a number of years, and then because of national TV cable exposure and other things, we have become again, a very national university. And so that would -- so I'm talking about from an online student perspective. From a ground-based perspective, we have -- we were at 60% of our students were from Arizona at one time, that's down to 50% now. We expect that to be significantly under 50% by next year as the campus grows. And so for a number of years, this was primarily on the ground campus, it was Arizona and California. But it -- we are expanding our reach into different parts of the country now and are getting very high-quality students and are very excited about that.

Operator

Our next question comes from Jeff Meuler of Baird.

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

Brian, if you do decide to pursue the for-profit service or strategy and not-for-profit university, what will the plan be for the dorm ownership? Like which -- would that be with the not-for-profit University? Or the dorms be owned and serviced by the for-profit service or co?

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

If you go back to the years to what we talked about 2 years ago, the plan was for the not-for-profit University to acquire the dorms. And there's been no discussion that's doing something different than that. So I would assume that if we did move forward, it would be the not-for-profit would own those dorms.

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

Okay. And then on the guidance assumption in terms of the mid-single digit online enrollment growth in Q4, you just sustained high single digits into a meaningfully tougher year-over-year comps, so on the Q4 assumption, are you seeing the deceleration and to the extent to which you are, at this point, can you call out, I guess, any color in terms of geographies, programs, et cetera, where deceleration may be occurring?

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

No. Not really. Not in terms of geography or really in terms of programs, just a slight deceleration based upon really the law of large numbers. We have 90,000 students now. So we've tried to be very careful in saying that over the last couple of years, we expect this eventually to slow down and it to become a normalized rate and we just expect that to start fairly soon.

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

When we did our budgets for the beginning of the year -- at the beginning of the year that the assumption that was in their is because of how -- what the numbers were a year ago, just as Brian said, the law of large numbers in a period of time that's not your typical back-to-school time, and so that's still our expectation at this point.

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

Okay. But are you like seeing it in October to starts and lead flow? Or is it more the guidance assumption?

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

The assumption.

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

Okay. And then can you just help me on the cybersecurity warfare facility? What kind of programs are these? Are these online programs? Are they on ground programs? Are they traditional age students? Are they degreed? What types of offerings are you envisioning there?

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

All of what you just said. We have formed a partnership with an organization called ACTRA, which has some very high profile players in it around a national movement to strengthen everything around cybersecurity, and so we -- in Arizona, we have a warfare range in the East Valley. They came to us and asked if we would work with them on warfare range in the West Valley, which we have and we've now completed that, and we're bringing in some pretty high-profile people for training. We'll turn all of that into degree programs and certificate programs for students. There are -- depending upon who you believe, 500,000 jobs available right now in cybersecurity positions. And so I think the opportunity is tremendous and we would like to be a big part of that.

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

Okay. And then could you just give us some general sense of what the annual revenue is at this point for the ancillary? I'm not talking about the room and board, I'm more thinking the coffee and golf and [spirit world] and all of those things. And -- so what's the rough annual revenue run rate for them? And what's the margin profile on it?

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

Off the top of my head, I don't remember the exact number once you take out food and that sort of thing. But it's clearly less than $100 million. It's probably less than $50 million. And the margins on that are less than our margins for the core business. So they're somewhere between 5% and 15% margins.

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

With that, we've reached the end of our third quarter conference call. We appreciate your time and interest in Grand Canyon Education. If you still have questions, please contact either Dan Bachus or Bob Romantic. Thank you very much for your time.

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 great day.