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LOPE - Q2 2018 Grand Canyon Education Inc Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Second Quarter 2018 Grand Canyon Education Earnings Conference Call. (Operator Instructions) As a reminder, this conference call may be recorded. I would now like to turn the call over to Dan Bachus, Chief Financial Officer.

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

Thank you. Joining me on today's call is our Chairman and CEO, Brian Mueller. 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 report on Form 10-Q and current reports on Form 8-K. We undertake no obligation to provide updates with regards to the forward-looking statements made during this call, and we recommend that all investors review these reports thoroughly before taking a position in GCE. And with that, I will turn the call over to Brian.

Brian E. Mueller - *Grand Canyon Education, Inc. - CEO & Chairman*

Good afternoon, and welcome to Grand Canyon Education's Second Quarter Fiscal Year 2018 Conference Call. On July 1, 2018, GCE consummated an Asset Purchase Agreement with Gazelle University. Prior to the transaction, GCE owned and operated Grand Canyon University. Upon the closing of the transaction, Gazelle University changed its name to Grand Canyon University or New GCU.

As a result of the transaction, GCE transferred to new GCU the real property and improvements comprising the GCU campus as well as tangible and intangible academic and related operations and assets related to GCU. And New GCU assumed liabilities related to the transferred assets. Accordingly, GCU is now owned and operated by new GCU. In connection with the closing, GCE and New GCU entered into a long-term master services agreement, pursuant to which GCE will provide identified technological counseling, marketing, financial aid processing and other support services to New GCU in return for 60% of new GCU's tuition and other revenue.

Accordingly, the result of operations discussed on this call reflect GCE's operations prior to July 1, 2018, which was made up exclusively of the operations of GCU. The results of operations in future periods will reflect the operations of GCE as a service technology provider, and there will be some updates as to the progress being made by GCU and its growing role in higher education.

As a result of this transaction, various aspects of GCE's operations have changed in important ways. These changes include, but are not limited to the following: GCE no longer -- owns and operates a regulated institution of higher education, but instead provides a bundle of services in support of New GCU's operations.



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These services include technology, academic counseling services and support, and marketing for New GCU's ground traditional and online students. Technology services include the ongoing improvement, maintenance of educational infrastructure, including online course delivery and management, student records, assessment, customer relations management and other internal administration systems.

Academic services include providing support for curriculum and new program development, providing support for faculty training and development, technical support and assistance with state compliance.

Counseling services and support include team-based counseling and other support to prospective and current students as well as financial aid processing.

Marketing and communications includes brand advertising, marketing to potential students and other promotional and communication services. GCE will also provide, at least initially, back office services such as accounting, human resources and procurement services. While GCE has never operated as a third-party service provider regulated by the Department of Education until now, all the services that it will provide to New GCU under the master services agreement are services that it has always provided internally and supported GCU's academic operations prior to the transaction.

As a result, while GCE is limited to no experience operating as a service provider to third parties, we believe that our significant investment in technological solutions, infrastructure and processes to provide superior service to students, our experience and expertise in these service areas, our experience providing such services at the scale required for New GCU to continue to operate in a manner consistent with past practices and the fact that GCE retained all of the assets and employees involved in the delivery of such services will enable it to perform in a manner and to the service levels required under the master services agreement and also positions GCE to engage additional University customers in the future.

My objective today is to provide an overview of who GCE is as a technology and education services company. In the short term, GCE's goals are to use the people, interconnected processes and advanced technologies that have been built over the last 10 years to enable its only current customer, GCU, to be the most productive, efficient and therefore premier teaching institution in America.

I want to review the major operational service areas GCE will provide to GCU, and in doing that position GCE as a provider that has been able to support over 90,000 GCU students and is therefore well positioned to support additional partners in the future.

The first area is program and curriculum development. GCU has total control of all academic programs, courses, content, learning outcomes, et cetera. GCE has a curriculum design and development department that will provide design services to the 9 GCU colleges, especially as it relates to online delivery. This department has 70 highly skilled professionals that in the 2017/'18 school year produced 20 new programs, certificates and emphasis areas, which included 279 new courses. 24 new programs are targeted for release in 2018/'19. GCE built its own proprietary system to support this work. Second, the University employs the faculty and sets all the standards for who becomes a member of the faculty determines performance expectations, rank, advancement, pay levels, et cetera.

GCE has a department of 55 professionals that support the University in doing this work. In 2017-18, this department collaboratively recruited and trained 72 new full-time faculty and 707 adjunct faculty. It also provided more than 1,300 training sessions that had more than 17,000 attendees in the year just ended.

GCE built its own proprietary system to support this work. Third, GCU sets the admissions standards for students in all the programs the University offers. GCE has an admission support department. It has 24 full-time professionals and 30 student workers.

The higher education admissions process has become increasingly complex over the last 2 decades. Students are earning college credits while in high school. Students are transferring from community colleges to 4-year institutions.

Students are transferring between 4-year institutions and they are using methods other than class attendance to earn credits.

GCE has developed an extremely robust, propriety system to quickly and efficiently evaluate transcripts and build schedules for prospective students.



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The transcript evaluation system is an automated system powered by machine learning. Its power comes from the database of previous evaluations that can then be automatically applied when those courses are seen in the future.

The database of previous evaluations is constantly building, as new courses and institutions are added. Currently, there are 1.3 million courses in the database, and 70% of courses evaluated are already in the system. In 2017/'18, 194,860 transcripts were evaluated and students knew about accepted credits in an average time of 1 hour and 44 minutes.

At many institutions, prospective students don't have that information for months.

Fourth, Grand Canyon University sets tuition, room board and fee levels for all students in its 9 colleges in over 230 graduate and undergraduate degree programs, emphases and certificates. GCE has a financial aid department of 90 professionals that do all the processing of financial aid work for students.

GCE has built 7 interconnected systems to do this work. In the 2017/'18 school year, 717,306 work streams were completed, including all touched files in support of the financial aid process. Lack of financial transparency has become a major problem in higher education.

GCE has built up a propriety system called the degree plan calculator that provides students the cost of their entire program, not just for a semester or year, it provides complete detail regarding any loans the student takes out along with repayment amounts and options.

100% of GCU students are provided this information before they start the program.

Fifth, Grand Canyon University sets optimum class sizes for all the courses in its 230 plus academic programs. On ground, the University has an average class size of 25 and online the every class size is 17.

GCE has a class scheduling department of 15 professionals and its own proprietary system that does all this work. In 2017/'18, there were a total of 611,638 classes scheduled for both on ground and online students.

Six, GCU provides a tremendous amount of academic and career counseling to students through its faculty. The small class sizes and extended office hours provide students with an extensive amount of time with faculty.

GCE has an advising department of 360 professionals that provide the students with the practical help they need with scheduled building, financial aid, field placements, et cetera.

Each student is assigned adviser that stays with them through graduation. GCE has built or implemented 11 systems that enable advisers to closely monitor students as they move through their academic programs. Just to give one example, an early alert system notifies an adviser if the student misses a class, fails an assignment or shows weakness in the foundational area like writing or math.

Seven, Grand Canyon University designed its learning management system called LoudCloud. The system was designed around the pedagogical principles that guide our thinking about curriculum and instruction. Whether in a face-to-face or online classroom, most of the University's classes are taught in a small group environment that is instructor-led, highly interactive and collaborative. Rich content that originates from a myriad of sources is coupled with a robust discussion environment.

Students most often respond to the content discussion through written work. The writing assignments are designed to promote critical thinking, which is often connected to solving real-world problems. There are many systems connected to LoudCloud that students will learn to navigate.

GCE has a team of 155 professionals that provide 24 hours a day, 7 days a week technical support for students and faculty. In 2017/'18 school year, the team handled 252,149 tickets from around the world. There are 2 systems that GCE uses to do this work.

Eight, Grand Canyon University sets the vision for the marketing messages that it uses to explain to the world who it is as a University.



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GCE has a department of 129 professionals to implement that mission. The department uses a combination of 28 systems in partnerships to accomplish its work. Grand Canyon University has 3 departments that would be replicated on the GCE side when GCE takes on additional partners.

First are the 15 academic excellence centers that are on the GCU campus. These centers provide one-on-one or group academic assistance to students who want to excel in the classroom.

Centers provide both face-to-face and online support. In 2017/'18, these centers provided over 90,000 sessions to over 11,500 unique students. These centers used 3 core systems to provide this academic support.

Second, GCU provides its students with an electronic library that has a 140 databases. 90,900 journal titles, 224,000 e-book titles, 23,200 streaming video titles and 38,300 physical texts.

In the 2017/'18 school year, GCU students completed 28 million searches and 10.8 million full-text retrievals. This is at a cost of \$2.7 million annually. A similar electronic library would be made available through GCE to future partners.

Third, GCU has a deep culture of assessments supported by faculty, technology and processes. Learning assessment and improvement of learning are reflective of the mission, vision and foundational statements of the University. The ultimate goals of assessments are to enhance student learning, facilitate student persistence, increase faculty engagement and demonstrate purposeful effort towards institutional effectiveness.

GCE has a department who will work with the faculty to support this work. GCE believes that it is well equipped to provide services to future partner institutions. First, it has invested over \$200 million over the last 10 years to develop systems that automate key processes that enable it to scale to hundreds of thousands of students.

Second, GCE is capable of supporting not just core academic functions, technology and marketing, but many additional key processes that surround those functions. Namely faculty recruiting and training, admissions, financial aid, accounting, technical support, assessing learning outcomes, et cetera. If you look at the contracts currently in the industry, GCU would expand the total number of automated services significantly.

New GCU is a separate nonprofit entity under the control of our independent Board of Trustees, none of whose members have ever served in a management or corporate board role at the company.

New GCU's Board of Trustees has adopted bylaws and a related conflict of interest policy that, among other things: prevent any trustee of New GCU from attending any meeting or voting on any matter as to which such trustee has a conflict of interest; establishes a special committee of independent trustees to oversee on behalf of New GCU all matters related to the master services agreement and New GCU's relationship with GCE; prohibits any trustee from having any financial interest in or role with GCE. Accordingly, GCE's relationship with New GCU, both pursuant to the master services agreement and operationally, is no longer as owner and operator, but as a third-party service provider to an independent customer.

While GCE believes that its relationship with New GCU will remain strong, new GCU's Board of Trustees and management will have fiduciary and other duties that will require them to focus on the best interest of New GCU.

Now turning to the results of operations. In the second quarter of 2018, enrollments grew by 9.6% and revenues grew by 8.5%. New working adult students attending GCU's online campus grew in the high single digits year-over-year. Operating margins are at 24.7% for the quarter. Net revenues were \$236.8 million in the second quarter of 2018, an increase of \$18.5 million or 8.5% from the \$218.3 million in the prior year period.

Operating margin for quarter two 2018 was 24.7% in the second quarter compared to 25.2% for the same period in 2017.

Net income was \$46 million for the quarter of 2018 compared to \$39.8 million in the prior year period. After-tax margin was 19.4% compared to 18.3% for the same period in 2017. Instructional cost and services grew from \$95 million in the second quarter of 2017 to \$102.2 million in the second quarter of 2018, an increase of \$7.2 million or 7.6%. This increase was primarily due to increases in employee compensation and related



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expenses and faculty compensation due to the increase in the number of staff and faculty to support the increasing number of students attending the University and increased benefit cost between years.

In addition, we had an increase in dues, fees and subscriptions and other instructional supplies between years primarily due to increased licensing fees related to educational resources and increased food cost associated with a higher number of residential students as well as increase in occupancy cost, including depreciation and amortization 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 decreased 30 basis points to 43.2%, primarily due to our ability to leverage our instructional cost of services across the increasing revenue base.

Bad debt expense stayed flat at 160 basis points year-over-year. Admissions advisory and related expenses as a percent of revenue increased 30 basis points to 14.5% from 14.2%, primarily due to increased employee compensation benefit cost between year and the revenue seasonality as a result of the summer break for the ground traditional students.

Advertising expenses, as a percent of net revenue, increased 40 basis points, from 11.3% in quarter two 2017 to 11.7% quarter two 2018.

General and administrative expenses, as a percent of revenue, increased 50 basis points to 5.1% in quarter two of 2018 from 4.6% quarter two of 2017.

This increase was primarily due to increases in legal and other professional costs incurred primarily as a result of our transaction discussed earlier.

We anticipate that GCU's enrollment will be at 98,500 at the end of the third quarter and 97,200 at the end of the fourth quarter. We anticipate that ground enrollment will be approximately 20,500 at the end of the third quarter and 20,300 at the end of the year.

With that, I would like to turn it over to Dan Bachus, our CFO, to give a little more color on our 2018 quarter -- second quarter, talk about changes in the income statement, balance sheet and other items as well to provide updated 2018 guidance and the financial implications of the transaction.

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

Thanks, Brian. Revenue exceeded our expectations in the second quarter of 2018 primarily due to higher enrollment and higher ancillary revenues.

Revenue per student decreased in the second quarter of 2018 compared to the prior year due to a shift in the timing of the start dates for its ground traditional students, resulting in 1 less revenue producing day in 2018. In addition, revenue per student for online students declined slightly between years due to a higher percentage of doctoral learners moving into the dissertation phase, which generates a significantly lower per student revenue and due to the timing of the graduations. Scholarships, as a percentage of revenue for all students, increased from 14.5% in Q2 2017 to 14.7% in Q2 2018, due primarily to an increase in online scholarships as a percentage of revenue, partially offset by a decrease in ground scholarships as a percentage of revenue year-over-year.

Bad debt expense, as a percentage of revenue, stayed flat year-over-year at 1.6%. Our effective tax rate for the second quarter of 2018 was 23.3% compared to 28.0% in the second quarter of 2017. The lower effective tax rate year-over-year is the result of the Tax Cuts and Jobs Act, which was signed into law on December 22, 2017. The act reduces the corporate federal tax rate from a maximum of 35% to a flat 21% rate, effective January 1, 2018.

In addition, excess tax benefits of \$1.2 million and \$5.2 million from share-based compensation awards of passenger settled in the second quarter of 2018 and 2017 respectively was recognized.

We repurchased 10,000 shares of our common stock in the second quarter of 2018 at a cost of approximately \$1 million. We had \$96.2 million available under our share repurchase authorization as of June 30, 2018.

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Turning to the balance sheet and cash flows, total unrestricted cash and short-term investments at June 30, 2018, was \$298.2 million.

CapEx in the second quarter of 2018, excluding our offsite development of \$0.2 million, was approximately \$43.7 million or 18.4% of net revenue. Going forward, GCE's annual CapEx should range between \$10 million and \$15 million and be primarily software development and systems related.

We anticipate funding \$65 million of CapEx on behalf of New GCU through the secured note in the second half of 2018 and another \$100 million in 2019. This funding is to finish the 2018/'19 school year projects, which include 2 apartment-style residence halls, a classroom building for Jerry Colangelo College of Business and a parking garage and 3 apartment-style resident falls and a parking garage for the 2019/'20 school year.

We elected not to renew our revolving loan of credit of \$150 million, which expired on December 31, 2017, which resulted in lower quarterly interest expense in Q2 2018 as compared to prior year.

Additionally, we increased our capital spending in the current year, which resulted in higher capitalized interest as compared to the prior year. I'd like to spend a few minutes talking about the impact of the transaction on our financial statement, some of which you can see in the June 30 financial statement and some that will not occur until the period ended September 30, 2018.

On the June 30, 2018, financial statements you'll notice that we have reclassified certain assets and liabilities as held for sale as of June 30, 2018. These are the assets and liabilities that were transferred to New GCU on July 1.

The assets include all cash that had been considered restricted, all students accounts receivable, prepaid expenses and other assets related to future operations of New GCU, an \$869.1 million of fixed assets, including the University's campus and furniture and equipment for New GCU's employees.

The liabilities include deferred revenues and student deposits as well as certain accrued and other liabilities. In addition, GCE transferred \$43.5 million of unrestricted cash, of which \$33.9 million was part of the closing to offset the net liabilities assume and \$9.6 million was to fund employee compensation for New GCU employees.

As a result of the transaction, GCU received a secured note for the transfer of assets for \$869.1 million. We are not expecting to have a book gain or loss as a result of the transaction. However, we are expecting to incur expenses in the third quarter 2018 related to the transaction incurred on July 1, 2018, of approximately \$23.7 million. Included in this amount is \$17.4 million of share-based compensation expense resulting from the modification of previously issued restricted stock grants for New GCU employees that transferred employment for GCE and \$3.0 million asset impairment.

The guidance I will provide in a few minutes excludes those one-time transaction costs.

Last, I would like to provide color on the updated guidance we have provided for the rest of 2018. The revenue guidance for the third and fourth quarters of 2018 have been adjusted to reflect the 60% revenue share with New GCU with an increase due to the slightly higher-than-expected enrollments.

We are still analyzing the accounting classification of the fees received under the master services agreement but believe the entire amount will remain within operating income. We have provided projected revenues, operating margins, earning per share and diluted weighted average shares outstanding guidance for third and fourth quarters of 2018.

As you will notice, earning per share for the second half of 2018 is approximately 2.9% less than previous guidance, due primary to the expected dilution of the transaction, partially offset by a lower effective tax rate, although the impact of that dilution is primarily in the fourth quarter. GCE will still be seasonal due to significantly lower revenue in the second and third quarters as a result of the summer break for GCU traditional students. However, the seasonal effect will not be as great as previously.



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We estimate that GCE depreciation expense and share-based compensation expense will be approximately \$16 million and \$10 million, respectively, on an annual basis going forward, rising only slightly year to year. We estimate interest income and interest expense will be \$13.8 million and \$700,000, respectively, in the third quarter and \$14.3 million and \$700,000 in the fourth quarter, respectively.

Interest income is primarily related to the seller financing, and interest expense is up year-over-year as GCE will no longer be able to capitalize interest on the GCU campus construction.

Our effective tax rate will be 20.8% in Q3 and 23.1% in Q4. The effective tax rate for these quarters have been lowered from the 24.6% in Q3 and 25.3% in Q4 due to a lower expected effective tax rate as a result of the transaction and due to a \$3.7 million contribution in lieu of state income taxes in July, which has the effect of increasing general and administration expenses and decreasing income tax expense. The entire amount will be reflected as expense in the third quarter of 2018 and 3 quarters of that amount is reflected as a reduction in income tax expense in Q3 and a quarter of the benefit is reflected in Q4.

Excluding the contribution made in lieu of state income taxes, we estimate the effective tax rate will be 23.9% and 24.3% in those quarters. Although we might refer to these additional shares during 2018, these estimates do not assume repurchases.

The operating margin guidance, excluding the contributions in lieu of state income taxes for the third and fourth quarters of 2018, are 33.2% and 43.0% respectively. On a pro forma basis, we estimate the operating margins for the third and fourth quarters are lower than the same period in 2017.

As we have discussed previously, this decline in margins year-over-year in the second half of 2018 is primarily due to the reinvestment of a portion of the tax savings from the lower corporate federal tax rate into employees through bonuses, a higher 401(k) matching contribution and a higher medical benefits contribution.

We plan to provide some level of pro forma information as part of the third quarter results. Our long-term objective of margin expansion of 20 to 40 basis points on an annual basis has not changed.

I will now turn the call back over to Brian to share a few final thoughts.

Brian E. Mueller - *Grand Canyon Education, Inc. - CEO & Chairman*

As President of GCU, I would like to say a few words on behalf of the University. Grand Canyon University is now within weeks of starting its 10th academic year since I arrived in 2008. As explained earlier, the University has now come full circle and returning to its nonprofit roots.

The University will begin its academic year with approximately 20,500 students on campus and approximately 78,000 online.

The students attending GCU in 2018 don't look anything like the students that were attending in 2008. On GCU's traditional campus, the students in 2008 came with an average incoming GPA of 2.7. In 2018, the average incoming GPA of GCU's new class of approximately 7,100 new students will be 3.5. GCE use Honors College on campus has grown to over 2,000 students with an average incoming GPA of 4.1. GCU's working adult student population studying online, if you include RN to BSN students is now 60% graduate students. The dramatic improvement of the quality of GCU student body has led to some very important improvements in critical measurements. The graduation rates of the students who started at the University in 2014 is 58% for the traditional students on its campus and 65% for working adult students studying online.

43% of GCU's traditional students who graduate do so in 3 years and 63% graduate in 3.5 years.

This saves those families thousands of dollars. GCU's 3-year cohort default rate is now 6.2%. According to The Institute for College Access & Success, GCU students graduate with average debt levels less than state University students and far less than other private University students, a remarkable fact, given that GCU receives no state subsidies. GCU is now posting its graduation rates by college on its website. This has become important



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because the college scorecard publishes the graduation rates of universities based on a cohort of students from 2008. Unfortunately, the incredible transformation of GCU makes those numbers from 2008 to 2012 totally meaningless based upon who GCU is today.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Jeff Silber of BMO.

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

Thank you so much, and thank you for providing so much detail about what the 2 different companies, I guess, look like going forward. I'm curious, if I'm a student arriving on campus over the next few weeks and I was there last year, am I going to see any changes? Or is it kind of just business as usual?

Brian E. Mueller - *Grand Canyon Education, Inc. - CEO & Chairman*

The changes you will see are 2 new apartment-style residents hall, a brand-new Colangelo College of Business of 170,000 square feet. You'll see a new parking garage and most importantly, a new Chick-fil-A location as well as a new Taco Pell location. But as regards the transaction, no, the students didn't really talk much about us as if profit instruction, it made very little difference to them. All they knew was that they were at the University with brand-new facilities, classrooms, laboratories, residence halls.

They were in classes with motivated faculty members and low class size and they were paying tuition levels that if they were during the school year might allow them to graduate without absolutely any debt and so those things were the things that were important to them, our tax status meant little to them.

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

Okay, that's helpful. And I know you're focused on Grand Canyon University, which is like you should be focused on, but I always get questions about who's next or what's next. Can you tell us what kind of preparations you've made to go-to market to try to attract other partners?

Brian E. Mueller - *Grand Canyon Education, Inc. - CEO & Chairman*

We have a strategic alliance, educational strategic alliance department and we have 2 people within that department who we will be making calls on universities now as we move forward. We have done a lot of work internally to evaluate the full breadth of services that we could offer and then compare those to what we see being offered through other service companies. And so we are making preparations to go forward and to do something in the next 6 months. If I had to comment on specifically, what I see currently, it's a lot of the companies don't want to touch the important processes that allow you to scale, like the admissions work, transcript evaluations, schedule building, processing financial aid, especially in a borrower-based environment. Those are things that we've built automated systems for and we probably wouldn't want to partner unless we were able to handle those things, financial aid being an important consideration. Most often a private University will have small financial aid department that takes in financial aid files over the course of the entire year for the incoming class in September, and so you spread that workout over 12 months. We have the capability of literally processing thousands of financial aid files and building schedules on a monthly basis.

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And so that's one of the things that we have spent time thinking about and that we will be part of our thinking as we go forward, which is look for partners that want to scale programs. And we have the ability from an administrative processing perspective to do that work for them. But the relationship will be just like this with GCU. The institution determines what its admissions requirements are. The institution determines what its tuition level are and its faculty requirements, et cetera. But we have the ability then to recruit and train the faculty. We have the ability to process the financial aid work. And so we're a little bit probably more excited now than we were before having looked at, what I think, our capabilities and potential is. The other thing is, we just have to -- we have to take a little time and make sure that we are positioned in the right place from a standpoint we don't want to cannibalize any of our old programs, and we need to look for universities whose programs wouldn't be cannibalized or who are in an geographic area where we could recruit students for them that would never be students at Grand Canyon University. So does that help a little bit?

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

Yes -- no, it does. So this could be dramatically different than what we see from some of the "other OPMs" out there that just really focus on programmatic bases in terms of a new MBA program or a new nursing program.

Brian E. Mueller - *Grand Canyon Education, Inc. - CEO & Chairman*

It could be. Yes, it could be. I mean, we are -- GCE -- those departments that are supporting GCU are capable of supporting now 90,000 students and growing in a very, very efficient way. And so scale, because of the automated systems and the \$200 million we've invested in that, are not an issue for us. And so yes I think it probably would be different and when you think about the revenue split, and I know you guys look at -- the 60% revenue split, when you look at the services GCE is providing for GCU and could provide for other institutions, there's a lot of added value there for universities.

Operator

Our next person come from the line of Peter Appert of Piper Jaffray.

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

Brian, just a point of clarification on potential new clients. So you -- would you consider offering some of the support services on an ala carte basis? Or do you want to have a sort of more of a full-service relationship with potential University clients?

Brian E. Mueller - *Grand Canyon Education, Inc. - CEO & Chairman*

I think that's a very interesting question. I think it can go both ways. The focus right now is on individual clients, individual customer, a University. I think we could potentially offer a sense out of the services, but we could also potentially offer services for an entire system, for example. And the way we're thinking about it now -- and also I do think we can create win-win situations. We made this huge investment, leveraging it for Grand Canyon University has been tremendous, but we do think it could potentially be leveraged for Universities or systems in a way that would benefit students on both sides of it. But we're just at the beginning of it. We have got to have lots of meetings and lots of discussions, and we want to take, like we said previously, about 6 months to make sure that we are placed in the right place in this space.

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

Understood. And then the -- Brian, the high single-digit start growth you highlighted in your comments, I think that's a bit of an acceleration from what you saw last quarter. Number one, could you just confirm if that's the case? And then number two, any color in terms of programmatic areas or specific offerings that are driving the enrollment growth or the start growth, rather?



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Brian E. Mueller - *Grand Canyon Education, Inc. - CEO & Chairman*

It's a slight -- yes, it's a slight acceleration, and what we can attribute that to, we don't know in the immediate will be -- the starts that we're getting from the new programs are really helping. And so continuing to develop new programs based upon where the economy is going to go and where the jobs are going to be is a very important part of our strategy. To say that the slight acceleration was a little bit of a tailwind based upon the anticipation of a not-for-profit status is too early to say that. We just -- but we don't know what -- how many people didn't pick up the phone because, well, it was for-profit institution. It's impossible to tell exactly how many that was, we'll see in the coming months. But I wouldn't put a whole lot into that slight acceleration in the short run.

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

Yes, and just to piggyback that, we -- our guidance for the year was mid- to mid-high single digit start growth depending on quarters. So we're generally in line with what we thought going into the year.

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

Okay. And then Dan, last thing. You mentioned roughly 2% EPS dilution, I guess, in the second half from the conversion. Do you think that's a good run rate number to think about as we look at the 2019 profitability?

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

Yes, I think it's appropriate to look at. I mean, obviously, we want to continue to show margin expansion. This year was a little bit different with the tax change, but we were planning on spending that money and have spent that money in the first half as well. And so, yes, I think that on an apples-to-apples comparison is probably a pretty good guess going forward.

Operator

Our next question come from the line of Jeff Meuler of Baird.

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

Just first administrative one, the -- so you gave us the (inaudible) with the Q1 performance in your back half is based on -- your back half guidance is based on the pro forma classification. Is there anywhere the Q2 numbers are provided on a pro forma basis? Or is that what you're providing when you report Q3? Just any help on the pro formas?

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

Yes, we're still working on that. Our plan -- our -- we're hopeful just to provide second, third and fourth quarter pro forma information from '17 next quarter as we release the Q3 results.

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

And for Q2 of 2018, that's not provided today.



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

Yes, correct.

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

And then, Brian, you listed off all the capabilities of GCE and at the end there was, like, 3 capabilities, I think that you said your GCU capabilities that would need to be replicated. Could you just kind of go back to that not as much what they are, but -- is the message that you would need to build out certain additional capabilities at GCE before you'd be able to provide service -- school services to other universities or just -- I guess just help me connect the dots on the message you were trying to convey there?

Brian E. Mueller - *Grand Canyon Education, Inc. - CEO & Chairman*

It wouldn't be building them out. They are already built out. It would be leveraging them for new partners. And so those are things that we've kept on the GCU side because of how core they are to our academic mission. But those are things that if a University felt like they would add to their core mission, we could certainly replicate those on the GCE side and that would be mainly a matter of leveraging of the investment that we've already made.

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

Okay. And then capital allocation and I guess what are the priorities now. I understand you're still funding some of the CapEx via an expanded counterparty note, but capital allocation priorities and do you wait to get the full Department of Education change in control approval before you, I guess, change the priorities?

Brian E. Mueller - *Grand Canyon Education, Inc. - CEO & Chairman*

No, the priorities for GCE going forward are software development, continue to automate services, to continue to use technology to enhance everything that we do so that students and faculty can get the very best experience in the classroom that we can provide. That's mainly what GCE will be focused on. And then GCU will continue to build out its campus. And right now we're going to start to follow up with 20,500 students. Our goal is to build the University on the ground campus out to 30,000 students in the next 4 to 6 years, and so that will require CapEx investment in the early years that's going to come in the form of the increase in the note. But as the cash builds up for the University, it will be able to afford its own CapEx development. And what we do then past 30,000 students is -- if we still have a decision to make. But the value proposition at GCU is providing for families and traditional students who are now coming from all over the country is so significantly superior in terms of the tuition rate that's 2/3 less than most private University tuition rates, a very affordable room and board. The low debt levels comparatively speaking. The ability to do significant dual-enrollment and graduate in 3 years. That value proposition when you compare it to the kids in the University system in California, they're taking 5 and 6 years to graduate is so significant that we'll just have to figure out once we get the 30,000 students on the campus what is our next move, because it's clearly -- we could provide service for a great deal more than 30,000 students with the value proposition advantage that we have.

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

Okay. And then just finally, could you just maybe talk about your targeted digital marketing capabilities as I tend to think about the GCU historical advertising success, it's more reliant on, like, national TV advertising and I know there's others components to it, but a lot of the school services, online program management space is more targeted digital marketing. So if you could talk about the marketing capabilities and how transferable they are to potential other clients?



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Brian E. Mueller - *Grand Canyon Education, Inc. - CEO & Chairman*

Well, they're significant. When we talk about the Internet and digital marketing, we're heavily involved in all forms of social media communication, and so it's not that we withdrew from that, but -- the only thing that GCU has withdrawn from is the Internet lead-generating companies. That was a process that was tremendously fruitful in the late 80s and through the 90s, but now that there are all these players seeking working adult students who want to study and earn degrees online, that thing has deteriorated tremendously. And so we moved out of that into more traditional forms of marketing and advertising, but those also include lots of work with social media platforms, just not in the way that we would be working with lead aggregators. But the -- an advantage that we're going to have is that creative capability, but also the buying capability. We have a lot of leverage from a buying perspective, and if we add partners and create -- help create media or advertising campaigns for them, our ability to buy the media and have that as part of our package is significant. And so now there's going to be some learning that goes on with all of that, because we envision that there will be some targeted marketing based upon the geographic placement of certain partners. They're more likely to draw students in that area that they reside in and in those areas we don't have as good of -- as much of an opportunity. And so we'd have a lot of learning to do with regard to geotargeting, media placements and those kind of things, but we do have an experience group and significant buying capacity that we'd hope to leverage.

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

We reached the end of conference call. We appreciate your time and interest in Grand Canyon Education. If you still have questions, please contact myself, Dan Bachus. Thank you very much.

Operator

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

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