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LOPE - Q2 2019 Grand Canyon Education Inc Earnings Call

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PRESENTATION

Operator

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

At this time, I'd like to turn the call over your host to, Dan Bachus, CFO. Please go ahead, sir.

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 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 position in GCE.

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

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

Good afternoon, and welcome to the Grand Canyon Education's second quarter of fiscal year 2019 conference call.

During the second quarter of 2019, enrollment in the programs at our partner universities, for which we provide services, increased 11.4% to 90,906. This increase includes 3,316 enrollments in programs serviced by Orbis Education as of June 30, 2019. New working adult students attending our partner institutions grew in the low teens year-over-year. On a comparable basis, total enrollment grew 8.1% and new enrollments grew in the high single digits.

I want to begin by addressing the issues regarding 2U. They have been leaders in the OPM space, and we wish them nothing but the best going forward. However, I want to be clear about how the GCE strategy is different and why we believe we will be successful. Number one, the Grand Canyon University online strategy is the strategy being replicated throughout the country. Namely, taking academic programs that have been designed to teach traditional students in a face-to-face environment on a campus and redesigning them to be delivered online to working adult students. This is the quickest and least expensive way to begin operating in this space. Although, this space is very competitive, Grand Canyon Education has some significant advantages. Number one, it has the world's largest and most comprehensive platform to deliver both academic and operational services to GCU and other partners going forward. For the same or very similar revenue arrangements, GCE will offer over twice as many services, including operational services that most OPMs don't offer, but will allow programs to be offered at scale. These are fully automated services that include the following: programming curriculum design; the learning management system; faculty services, including recruitment, training and assessment; admissions intake, including transcript evaluation; comprehensive financial aid services; automatic class scheduling; fully developed academic and counseling services, including course reminder calls; practitioner or licensure follow-ups, schedules built or changed and technical support. These services will be offered in addition to the advertising and enrollment services, which are common in this space.

Number two, GCE is already the biggest player in this space with 2,600 very experienced staff members serving over 80,000 students on a $200 million platform producing very favorable outcomes. Those outcomes include: high graduation rates, low average debt amounts, low cohort default rates, good and still improving 90/10 rates as well as GCU's programs meeting the formal gainful employment guidelines. Adding additional partners into this already large proven model will put a minimum of initial strain on the GCE operations and its financials.

The next point is very important. GCE is not looking for many new partners with a lot of very small programs. We are looking for 3 or 4 partners that want to scale to approximately 5,000 students over a 5- to 7-year period. We want to make sure that our partners are differentiated based on either brand, geography or program mix. We also want to avoid partners and programs with extremely high price points resulting in $80,000-plus master's degrees. These factors will produce good results for students, GCE, the partner institutions and our investors.

Number two, Grand Canyon Education is providing services to Grand Canyon University's traditional ground campus, which has become a very unique asset. The GCU traditional campus is going to grow to over 30,000 students in the next 5 years. This growth is happening at very low tuition rates, has become profitable and GCU will continue to reinvest its profits to build out its campus. This competitive advantage GCU ground enjoys is unique and transformative in higher education. $1.5 billion has been invested into the campus in the last 8 years and it has been ranked the [8th] (corrected by company after the call) best campus in the country. GCU has built out 9 colleges with over 230 academic programs and continues to grow with very high-quality students.

Number three, the Orbis acquisition is a second very unique asset. While the rest of the country is rushing into the GCU online very crowded space, Orbis is uniquely differentiated. It involves ground classroom and laboratory infrastructure located in strategic markets combined with online delivery. There is a huge need for the health care professionals it produces and there is a significant positive value proposition for its graduates. These locations, programs and students don't cannibalize any other GCE University partner students. GCE is in a strong position to support the rapid expansion of Orbis. Orbis had 19 partner schools under contract at the close of quarter 2 and expects to sign either 2 or 3 new partners by the end of 2019. This will bring the total number of Orbis partner schools to either 21 or 22 by year-end. 12 of Orbis' 19 partners are currently enrolling students across 19 sites, with 4 new sites set to open by year-end. In 2020, we plan to open between 6 and 9 new sites, which is higher than the 4 to 8 new sites that we originally projected. 6 of the possible 9 new sites will represent partners who are opening their first sites, with the remaining 3 with partners who have a site already opened but who are adding additional sites. This represents more than the necessary amount of activity to achieve a greater than 35% enrollment growth rate in programs serviced by Orbis Education in 2020.

In summary, the OPM space is still a relatively new and evolving space, and GCE has a unique and differentiated strategy that is unlike any that currently exists.

Now turning to the results of operations. As a reminder, beginning July 1, 2018, the results of our operations do not include the University operations of GCU, but rather reflect the operations of GCE as a service technology provider. Therefore, for compatibility purposes, we will discuss amounts on an as adjusted basis as is discussed in a minute. Additionally, on January 22, 2019, GCE completed the acquisition of Orbis. Therefore, the results for the second quarter of 2019 include Orbis' financial results for the entire quarter. Service revenues were $174.8 million in the second quarter of 2019 compared to $236.8 million of University-related revenue in the prior year. Had the GCE-GCU transaction occurred on January 1, 2018, comparable service fee revenue would have been $142.1 million in the second quarter of 2018. This represents an increase of 23% between second quarter of 2018 and second quarter of 2019 on a comparable basis. The increase year-over-year in comparable as adjusted revenue was primarily due to our Orbis acquisition on January 22, 2019, and the increase in GCU enrollments between years. The partnership agreements that were acquired as part of the Orbis acquisition generally generate a higher revenue per student than our partnership with GCU as these agreements generally have higher revenue. The Orbis partners have higher tuition rates than GCU and the majority of these students are studying in the accelerated Bachelor of Science and nursing program, so these students take, on average, more credits per semester. End of the period enrollment increased 11.4% quarter-over-quarter to 90,906 from 81,620. As adjusted operating income and as adjusted operating margin for the 3 months ended June 30, 2019, were $53.1 million and 30.3%, respectively. As adjusted operating income and as adjusted operating margin for the 3 months ended June 30, 2018, were $44.7 million and 31.5%, respectively. GCE will continue to invest profits to create additional educational infrastructure for our partner institutions that will create more opportunities for students and families. Technology and academic services grew from $10.7 million in the second quarter of 2018 to $22.5 million in second quarter of 2019, an increase of $11.8 million or 111%. This increase was primarily attributable to the partner agreements acquired in the Orbis acquisition, which require certain technology and academic services, including headcount, classroom, facilities and equipment to be provided to each University partner. These costs along with the increased cost to service our existing client, GCU's increased enrollment resulted in the increase. As a percent of comparable revenue, these costs increased 540 basis points to 12.9% from 7.5% primarily due to the partner agreements acquired requiring a higher level of technology in academic services than our partner agreement with GCU. Counseling services and support expenses grew from $50.8 million in the second quarter of 2018 to $54.3 million in second quarter of 2019, an increase of $3.5 million or 6.8%. This increase was primarily attributable to the partner agreements acquired in the acquisition, which require certain counseling services and support, principally headcount to be provided to each University partner. These costs, along with the increased cost to service our primary University partner, GCU's increased enrollment resulted in the increase. As a percentage of comparable revenue, these costs decreased 470 basis points to 31.1% from 35.8% primarily due to the counseling services and support cost to service the acquired partner agreements being less as a percentage of revenues than the cost to service GCU and due to our ability to leverage our counseling services and support expenses across an increasing revenue base.

Marketing and communication expenses as a percent of comparable revenue increased 20 basis points from quarter 2 2018 to quarter 2 2019. This increase is primarily due to the advertising cost associated with marketing our new University partners' programs. General and administrative expenses increased $3.4 million between years and as a percentage of comparable revenue, increased 120 basis points to 5.3% in quarter 2 2019 from 4.1% in quarter 2 2018. This increase was primarily due to increases in employee compensation and benefit cost between years and other administrative expenses, in occupancy and depreciation, and in professional fees, including audit and legal expenses. Our increases in employee compensation, occupancy and depreciation and other general and administrative costs are primarily related to the acquisition, including additional headcount and office space in Indiana.

With that, I would like to turn it over to Dan Bachus, our CFO, to give a little more color on our 2019 second quarter, talk about changes in the income statement, balance sheet and other items as well as to provide 2019 guidance.

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

Thanks, Brian. Included in our Form 8-K filed with the SEC, we have included non-GAAP net income and non-GAAP diluted income per share for the 3 months ended June 30, 2019. The non-GAAP amounts exclude the tax affected amount of the amortization of intangible assets and the loss on transaction amounts included in our consolidated income statement. The amortizable intangible assets acquired in the Orbis acquisition totaled $210.3 million, and amortization expense in the second quarter of 2019 was $2.2 million. We believe the non-GAAP financial information allows investors to develop a more meaningful understanding of the company's performance over time. As adjusted non-GAAP diluted income per share for the 3 months ended June 30, 2019, is $1.09. Service revenue exceeded our expectations in the second quarter of 2019 due to slightly higher revenue per student. GCU and Orbis enrollments were generally in line with our expectations. Included in investment interest and other is a onetime gain of $2.1 million. This resulted in $0.03 of the earnings beat. Our effective tax rate for the second quarter of 2019 was 21.7% compared to 23.3% in the second quarter of 2018 and our guidance of 24.5%. The lower-than-expected effective tax rate is due to a recent law change with respect to Arizona state taxes and higher-than-expected excess tax benefits to $2.2 million in quarter 2 2019 from $1.2 million in quarter 2 2018. The lower-than-expected tax rate resulted in $0.04 of the earnings beat. We repurchased 3,000 shares of our common stock in the second quarter of 2019 that cost us $0.3 million and another 10,000 shares at a cost of $1.2 million in July. We had $77.8 million available under our share repurchase authorization as of June 30, 2019.

Turning to the balance sheet and cash flows. Total unrestricted cash and short-term investments at June 30, 2019, were $80 million. Restricted cash and cash equivalents were $300,000 as of June 30, 2019, and represents pledged collateral for a newly acquired lease site. GCE CapEx in the second quarter of 2019, including CapEx for new Orbis partner sites, was approximately $5.1 million or 2.9% of net revenue. We continue to believe that GCE's 2019 CapEx should range between $20 million and $25 million, consisting primarily of software development and the buildout of Orbis partner location. We funded CapEx on behalf of GCU through the secured note of approximately $139.9 million in the second quarter of 2019, which includes an advance of $99 million for estimated capital expenditures through the end of 2019. Some amounts may be repaid during the 6 months remaining in the year ended December 31, 2019. This funding is to finish the 2018-'19 school year projects and for the initial cost to build 3 additional apartment-style residence halls, a classroom building and a parking garage for the 2019-'20 school year. Based on recent conversations with GCU, it continues to be likely that the University will not request us to continue to fund its CapEx after this year as the University anticipates they will be able to fund its own CapEx moving forward.

Last, I would like to provide color on the guidance we have provided for the rest of 2019. The guidance that we have provided continues to be non-GAAP, as adjusted net income and as adjusted diluted income per share, as we exclude amortization of acquired intangible assets and the loss on transaction. We have increased revenue guidance for the full year due to the second quarter beat. We have not adjusted revenue for the second half of 2019, but have increased revenue guidance for the third quarter and lowered it by the same amount in the fourth quarter as Orbis revenue will be slightly higher than initially predicted in the third quarter, but less in the fourth quarter due primarily to timing differences in the cohort start dates. Excluding the effect of the contribution made in lieu of state income taxes that I'll discuss in a second, we have raised operating margin for the third quarter from 31.1% to 31.8% and lowered it in the fourth quarter due to the Orbis revenue shift and due to slightly higher projected Orbis spend in the fourth quarter on new site openings. All other expense assumptions remain the same for the second half of the year.

In July, we made $4 million of contributions made in lieu of state income taxes, which has the effect of increasing general and administrative expenses and decreasing income tax expense. The entire $4 million of expense is recorded in G&A expense in the third quarter, while 3/4 or $3 million of this amount is recorded as lower state income tax in the third quarter and 1/4 or $1 million is included as lower state income tax in the fourth quarter. This, along with us revising our excess tax benefit estimates, result in our revised effective tax rate of 21.0% in Q3 and 22.6% in Q4. We have also revised our net interest income projections for the second half of the year based on the borrowings that took place in June, and our assumptions that no additional borrowings will take place the rest of 2019, but that some repayments might be made. We project net interest income in the third and fourth quarters of 2019 will be $13.0 million and $12.5 million respectively. Although, we might repurchase additional shares during 2019, these estimates do not assume repurchases other than those made to date.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) I show our first question comes from Jeff Silber from BMO Capital Markets.

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

Wanted to start with Orbis. You've been putting up some really good numbers in those programs since you purchased the company. I'm just curious, what has gone better than your expectations? Why does it seem to be growing faster than you might have thought?

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

I would say that the success levels of the initial partners have given a lot of confidence to the whole organization. We have been making the rounds and meeting with some of the universities, and every single institution not only wants to build their current location to larger amounts, but they want additional locations. And so it's the -- we happened to buy at a time when they were really starting to turn the corner. The NCLEX results are consistently high and they are consistently fitting their enrollment numbers. And so the confidence levels of the model are growing and people are very excited about expansion.

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

Okay. That's great to hear. I appreciate the color you gave on the overall OPM or managed services market. I'm just curious, is there any update in terms of potential timing on any announcements of any new partnerships from your perspective?

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

Yes. We are working hard. We have been on the road for 2 months now, and we're going back on the road next week for additional meetings with 3 potential partners, which will be -- we're down the road with all 3. Some of the meetings will include as many as 100 people from those partner institutions. And so I think it's a long kind of process the way it's been traditionally done in this OPM industry. But this is a little bit longer because we're not looking to pick off a program and prove we can do it well with 100 students or 200 students or 300 students. We really are looking for an institution, 3 or 4 institutions, like I said, whose president is behind this and is wholeheartedly behind it and who has their entire academic infrastructure behind it and excited about it. So that when we hit the ground running that we can produce not results that are nice, but not really, they don't really change anything. Grand Canyon University and Grand Canyon Education has fundamentally altered the economic structure of higher education. Our students now on our traditional campus here are, on average, going for less room board -- tuition room board fees than our average state university student in this country, probably 2/3 under the private universities' average student. And so if we can find the right -- and it's probably going to be private university partners in the Midwest or Northeast that want to scale to 5,000 -- between 5,000 and 7,000 students over a 5- to 7-year time period. It won't have as dramatic effect on their institution as it had on ours, but it will have a significant effect, and it will be transformative in a sense. And so making sure that we've got an entire institution versus just a couple of small programs is why it's taking a little longer. But we think that in the next -- or certainly, before the end of the year, we will have partners in place and start working towards starting students in the fall.

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

Okay. If I could just sneak one more in. Over the past few weeks, there's been some noise in the market about changes to state authorization rules in California and potentially limiting their residents from getting Title IV financial aid to go to an online nonprofit institution out of their state. Hopefully, this has been resolved. But do you think there was any impact on your upcoming enrollments for the next few quarters or so because of this issue?

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

No. No. We will be fine.

Operator

Our next question comes from Jeff Meuler from Baird.

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

Dan, thanks for the detailed guidance. I just want to make sure that I have it right because there's a lot of timing factors and moving around in terms of geography on the P&L with the contribution in lieu for the income taxes. So I just -- in terms of underlying, if I adjust for the timing and that movement, are the only 2 real underlying changes here flowing the upside from Q2 in and then other a bit of incremental expense for Orbis in Q4 like-for-like, given that your opening greater number of locations than previously contemplated? Are those the only underlying changes other than the timing and P&L movement?

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

Yes. You've hit it on the head. We are -- we have a little bit additional expense in the fourth quarter related to Orbis and we're making up for that with slightly higher interest income and slightly lower effective tax rate on a combined basis. Everything else is basically nets out. The revenue shift nets out and the other expenses other than the slightly higher Orbis expenses in the fourth quarter, all net out. So what you said is exactly correct.

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

Okay. And then, Brian, is there interest on your part that you would potentially do 3 OPM partnerships, just sign them all at once? And is there any framework for what, like, 2020 margin implications could look like? Just thinking if you would potentially do 3 OPMs plus you're stepping up the pace of Orbis launches, is there any sort of, like, intermediate-term margin framework you could provide?

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

I don't think that we would sign 3 at the same time. I think it is likely that we'll probably sign 2 within a reasonable amount of time. And the -- but if we do that in the next 60 to 90 days, we wouldn't actually be starting students until the fall. And so there would be some expense that would be incurred, but it would not be an extreme amount of success, it would have hugely material impact on the financials.

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

And the only thing I would add is I think there are still a lot of things that have to be resolved. As we've mentioned before, how material the upfront expenses are? How significantly -- the biggest factor in that is how fast the partner wants to scale. And so coming to agreement on that or them telling GCE how fast they want to scale is a critical component. So as soon as we have a partner in place and we have those plans finalized, we'll be able to give you a lot more detail on the impact it will have both on the expense side but then on the revenue side.

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

And are you saying fall 2019, you could have student starting at these programs or are you saying fall '20?

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

No. Fall '20. Fall '20. Fall '20. That's why we're not -- we might sign an agreement in the next 60 or 90 days, but we wouldn't start students for 9 months after that. But that's not like we're going to be throwing a bunch of expense in the first 30 days. That's -- no. And it could be those programs don't roll out even till January of 2021. So fall '20 or spring of 2021, I think, is as early as...

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

Fall '20 is the earliest, yes.

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

Got it. And then just as a follow-up to the other just question, the -- around kind of the Californians and state reciprocity or [REOs.] The -- so I guess you're saying you'd be in good shape. It sounds like Ed is going to accommodate the California proposal, but maybe it didn't tick off all of the boxes. Just -- if there continues to be future noise about this, so I'm thinking like if there would -- if the judge in the original court ruling would chime in or something. Even if there would be a period where California students were not eligible for Title IV, did the University or GCE have some sort of stopgap financing planned? Or did you not even go that far down the path given that it was so short lived?

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

What GCE was told by GCU is they continue to do the right thing for the students in terms of enrolling new students and retaining the students that it had. And it took the risk on its own balance sheet that the Department of Ed and the State of California would come to a reasonable conclusion on this and that financially aid would be disbursed. And so that's why there's really no impact on GCE. And frankly, other than a short-term cash impact on GCU, there was no impact on GCU. And if something happens in the future, I would assume that the same would occur.

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

We have reached the end of our second quarter 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

Thank you, ladies and gentlemen, for attending today's conference. This concludes the program. You may all disconnect. Good day.
