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Q3 2018 Grand Canyon Education Inc Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Q3 2018 Grand Canyon Education Earnings Conference Call. (Operator Instructions) As a reminder, today's conference is being recorded.

I would now like to introduce your host for this conference call, Mr. Dan Bachus, Chief Financial Officer. You may begin.

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 regards to the forward-looking statements made during this call, and we recommend that all investors review these reports thoroughly before taking a financial 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 Grand Canyon Education's Third Quarter Fiscal Year 2018 Conference Call. For those of you that are new to this story or missed last quarter's conference call, on July 1, 2018, GCE consummated an asset purchase agreement with GCU, formerly known as Gazelle University. Prior to the transaction, GCE owned and operated the university. As a result of the transaction, GCE transferred to GCU the real property and improvements comprising the university campus as well as tangible and intangible academic and related operations and assets related to the university. And GCU assumed liabilities related to the transferred assets.

Accordingly, GCU now owns and operates the university. In connection with the closing, GCE and GCU entered into a long-term master services agreement, pursuant to which GCE provides identified technology and academic services, counseling services and support, marketing and communications services and several back-office services to GCU in return for 60% of GCU's tuition and fee revenue. Accordingly, the results of operations discussed on this call reflect GCE's operations since July 1, 2018 as a service technology provider with currently 1 client, GCU.

During the third quarter of 2018, enrollment at Grand Canyon University grew at 8.2%. New working adult students attending GCU's online campus grew in the high single digits year-over-year, which exceeded expectations. New ground traditional enrollment also increased in high single digits year-over-year, which also exceeded our expectations.

To give you an idea of the size and scope of services GCE offered to GCU in the third quarter and could offer to other universities in the future, I am providing the following summary. First, from the curriculum development area, 4 new programs were released to the university for implementation. I want remind you that GCU is responsible to select all new programs. It is responsible for the content and learning outcomes of the programs and sets the admissions requirements. It also sets the faculty academic requirements to teach in the program. The new programs were a Bachelor of Science in Cybersecurity, Bachelor of Science in Health Information Management, Bachelor of Science in Nutritional Sciences and a Master of Science in Nursing, with an emphasis in public health nursing. In addition, there were 10 programs and certificates that were revised or updated.

Second, from the faculty services area, there were 22 full-time and 401 adjunct faculty recruited and trained. There were also 192 additional sessions of faculty training and professional development. Examples of these trainings include boosting student success, the first year experience, from theory to practice and creating collaborative classrooms.

Third, in the admissions area, a total of 33,886 transcripts were evaluated, which provides prospective students the information they need in order to make a decision to start a program.

Fourth, in financial aid, 199,320 files were touched.

Fifth, in the scheduling area, 14,614 classes were scheduled with an average class size of 15 in September.

Sixth, our academic counselors performed 550,000 activities on behalf of students in the quarter, including activities such as welcome calls to new students, course reminder calls, GPA concerns, attendance, finance changes, missing documents, practicum or licensure follow-up and schedules built or changed.

Seven, in technical support, a key aspect of supporting students in an online environment, 69% of calls were answered with no hold time and at placed on hold, the average time was 46 seconds.

Eighth, our advertising work was very efficient and provided the necessary coverage to exceed our enrollment goal.

Ninth, we continued to enhance our technology platform during the third quarter. We rolled out an in-house developed additional writing tool to all GCU students. This tool uses machine learning to provide feedback to students during the writing process and, in the future, will allow instructors to provide feedback and will actually grade written work. We also began a pilot on the GCU traditional campus of a platform we built to provide the required cloud resources and environment templates for exercises in our cybersecurity programming and other IT courses. This will allow us to enhance both traditional and online courses with real-world problems and do it at scale. We continue to use deep analytics surrounding all aspects of the learning process to apply artificial intelligence, to automate reactions and identify specific student support needs.

We continue to work at the process of adding new GCE clients. In the next 30 days, we will meet with 5 universities to discuss the possibility of a future partnership. We have built more than $200 million worth of technology to support students at the Bachelors, Masters and Doctoral levels who are pursuing degrees in an online environment. The differentiating characteristic of GCE is our ability to provide scale at high levels of quality. We will continue to take our time in identifying the right partners who have quality programs and are willing to provide them at scale. We will provide more information on our progress in the months to come.

Turning to the results of operations. Commencing 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. In the third quarter, GCE made changes to its presentation of operating expenses and reclassified prior periods to conform to the current presentation. GCE determined that these changes would provide more meaningful information as this new presentation provides transparency regarding the cost that will be incurred as a service provider and the cost that will not reoccur in the future as they are related to university expenses that were transferred to GCU in the transaction. The as reported and as classified amounts are presented in Note 3 to our consolidated quarterly financial statements for the period ended September 30, 2018.

In the third quarter of 2018, GCE's operating margins declined from 25.3% to 18.9%. But this was an anomaly as it was significantly impacted by the transaction-related expenses incurred in the third quarter of 2018 and the increased contributions we made in lieu of state income taxes in the third quarter of 2018 compared to the third quarter of 2017. Adjusted operating income and adjusted operating margin for the 3 months ended September 30, 2018, excluding cost incurred related to the transaction, including the loss on the transaction of $15.6 million, university-related expenses of $6.6 million and contributions in lieu of state income taxes of $3.7 million, were $55.3 million and 35.6%, respectively. Adjusted operating income and adjusted operating margin for the 3 months ended September 30, 2017, excluding 40% of university-related revenue, university-related expenses and the contributions in lieu of state income taxes of $2 million, were $50.7 million and 35.8%, respectively. Dan will discuss each of these costs in more detail in a few minutes.

After-tax margins as reported grew from 16.6% in the third quarter of 2017 to 21.7% for the current quarter, and net income as reported was $33.8 million for the third quarter of 2018 as compared to $39.3 million in the prior year.

Net income and earnings per share for the third quarter of 2018, adjusted for the impacts of the transaction and contributions made in lieu of state income taxes, was $51.4 million and $1.06, respectively. While net income and earnings per share for the third quarter of 2017, adjusted for the impact of the contributions made in lieu of state income taxes, was $39.8 million and $0.82, respectively.

Service revenues were [$155.5] (corrected by company after the call) million in the third quarter of 2018 compared to $236.2 million of university-related revenue in the prior year. Had the transaction occurred on July 1, 2017, comparable service fee revenue would have been $141.7 million in the third quarter of 2017. This represents an increase of 9.7% between third quarter of 2017 and third quarter of 2018 on a comparable basis. The increase year-over-year in comparable service fee revenue was due to an increase in GCU's enrollment and an increase in GCU's ancillary revenue resulting from increased traditional student enrollment.

Enrollment at GCU increased 8.2% between September 30, 2017 and September 30, 2018. As I indicated earlier, new working adult students attending GCU's online campus grew in the high single digits year-over-year, which exceeded expectations. New ground traditional student enrollment also increased in the high single digits year-over-year, which also exceeded our expectation.

The income statement data as a percentage of revenue is not comparable between periods for the third quarter. This is a result of a reduction in revenues associated with the company transitioning to an education service provider as of July 1, 2018. As a result, the company has calculated 60% of university-related revenue for the 3 months ended September 30, 2017, as adjusted non-GAAP net revenue, which is the percentage of GCU's tuition and fee revenue to which the company is entitled under the master services agreement in order to compare operating expense percentages, net of adjusted non-GAAP net revenue, on a comparable basis. For a reconciliation of these adjusted amounts to the as reported equivalent in our Form 10-Q, please refer to our earnings release.

Technology and academic services grew from $10.5 million in the third quarter of 2017 to $11.1 million in the third quarter of 2018, an increase of $0.6 million or 5.8%. This increase was primarily due to an increase in employee compensation and related expenses due to the increase in the number of staff needed to support our client, GCU, and its increased enrollment growth, tenure-based salary adjustments and increased benefit cost between years. As a percent of comparable revenue, these costs decreased 30 basis points to 7.1%, primarily due to our ability to leverage our technology and academic services personnel across an increasing revenue base, partially offset by the planned reinvestment of a portion of the savings provided by our lower tax rate in increased employee compensation and benefit cost.

Counseling services and support expenses grew from $46.1 million in the third quarter of 2017 to $51.1 million in the third quarter of 2018, an increase of $5 million or 10.9%. This increase is due to increased employee compensation and benefit cost between years, increased occupancy and depreciation expenses and increased dues and travel cost needed to service GCU and its enrollment growth. As a percentage of comparable revenue, these costs increased 40 basis points to 32.9% from 32.5% due primarily to the planned reinvestment of a portion of the savings provided by our lower tax rate in the increased employee compensation and benefit cost.

Marketing and communication expenses as a percent of comparable revenue increased 50 basis points from third quarter 2017 to third quarter of 2018.

General and administrative expenses increased $1.7 million between years and, as a percent of comparable revenue, increased 60 basis points to 6.5% in Q3 2018 from 5.9% in Q3 of 2017. This increase was primarily due to increases in contributions made in lieu of state income taxes to school sponsoring organizations from $2 million in the third quarter of 2017 to $3.7 million in quarter 3 2018. We anticipate that GCU's enrollment will be at 97,200 at the end of the fourth quarter.

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

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

Thanks, Brian. I first would like to spend a few minutes talking about the impacts of the transaction on our just filed financial statement. The transaction is described in detail in Footnote 2 to our financial statement.

However, I'd like to highlight some items that you might notice on the balance sheet, income statement and statement of cash flows. From a balance sheet perspective, we transferred the education-related assets and liabilities, including restricted cash, student accounts receivable, certain other assets, property and equipment, including the university campus, and furniture and equipment used by university employees, certain accrued liabilities, student deposits and deferred revenue to the university. The company received a secured note for these transferred assets in the amount of $870.1 million that earns interest of 6%, payable monthly. The company also transferred cash equal to $43.7 million, representing a working capital adjustment as part of the closing.

Except for identified liabilities assumed by GCU, GCE retained responsibility for all liabilities of the business arising from pre-closing operations. In connection with the transaction closing, our credit agreement was amended, such that the lenders released the collateral securing the company's obligation under the credit agreement and modified certain financial and regulatory covenants to reflect the fact the company no longer operates the regulated educational institution, and we provided to the administrative agent cash collaterals securing our our remaining obligations under the credit agreement until such time as the transaction has been approved by the U.S. Department of Education and agreed to collaterally assign our rights under the asset purchase agreement, the secured note and the master services agreement. The amount that is considered cash collateral is included as restricted cash on the consolidated balance sheet.

From an income statement perspective, during the 3 months ended September 30, 2018, the company's net income was reduced by $15.6 million, included in loss on transaction due to transaction costs of $3 million, an asset impairment of $3 million and the transfer by the company to GCU of cash of $9.6 million to fund the deferred compensation plan for GCU employees that were formerly GCE employees and that held unvested restricted stock of GCE that was forfeited upon the transaction. Included in the university-related expenses for the 3 months ended September 30, 2018, is $7.9 million of share-based compensation expense, resulting from the modification and vesting of previously issued restricted stock grants held by transferred employees, an employer tax expense of $0.2 million related to the share-based compensation modifications, net of reversals of employer-related liabilities that were not part of the transferred assets for the transaction of $1.5 million. The total cost included as loss on the transaction and university-related expenses during the 3 months just ended of $22.2 million was slightly less than $23.7 million of estimated transaction costs. Interest income on secured note of $13.5 million was slightly less than the $13.8 million that we had provided in our guidance for the third quarter due to the timing of the funding of the university's capital expenditures. As will be discussed later, this timing difference will continue in the fourth quarter, reducing slightly our projected interest income.

As Brian alluded to in his financial discussion, we made changes to the way we present operating expenses on our income statement and reclassified prior periods to conform to the current presentation. We believe these changes provide more meaningful information as this new presentation provides transparency regarding the costs that will be and would have been incurred as the service provider and the cost that will not reoccur in the future as they related to university expenses that were transferred to GCU in the transaction. The as reported and the as reclassified amounts are presented in Footnote 3 for each of the 4 quarters of 2017 and the first 2 quarters of 2018 the transaction also had an impact on our effective tax rate during the third quarter, which I will discuss in more detail in a minute.

From a cash flow perspective, the effect of the transaction is reflected as a disposition of $131.6 million in our investing activities. This represents a net cash transferred as part of the working capital adjustment of $43.7 million and the restricted cash transferred to the university at closing.

The funding of GCU capital expenditures during the quarter of $12.8 million is also considered an investing activity. $5.1 million of the increase in GCE capital expenditures between June 30 and September 30, 2018, of $11.3 million is related to GCE capital expenditures, with the remaining amount the result of university-related capital expenditures incurred prior to June 30, 2018, but paid during the third quarter of 2018. The $69.5 million accounts receivable due from GCU is a result of the service fees being paid a month in arrears.

With that, I will now provide color on the third quarter of 2018. Service revenues slightly exceeded our expectations in the third quarter of 2018, primarily due to GCU's higher enrollment and higher ancillary revenues. Revenue per student increased in the third quarter of 2018 compared to the prior year due to a shift in the timing of start date for our clients' ground traditional students, resulting in 1 more revenue producing day in 2018 and an increase in residential students as a percentage of enrollment.

GCU has not raised its tuition for its traditional ground programs in 10 years, and tuition increases for working adult programs have averaged 1% or less. Our effective tax rate for the third quarter of 2018 was 20.5% compared to 35.1% in the third quarter of 2017. This decrease is the result of a decrease in our effective tax rate, the lower income between years due to the cost incurred during the third quarter of 2018 related to the transaction and an increase in our contributions in lieu of state income taxes to school sponsoring organization.

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 reduced the corporate federal tax rate from a maximum of 35% to a flat 21% rate, effective January 1, 2018. Our contributions made in lieu of state income taxes increased from $2 million in Q3 2017 to $3.7 million in Q3 of 2018. We estimate our tax rate, excluding the impact of the transaction and the contributions made in lieu of state income taxes, would have been 24.8%, which is slightly higher than our previous estimate of 23.9%.

We've repurchased 23,139 shares of our common stock in the third quarter of 2018 at a cost of approximately [$2.6 million] (corrected by company after the call). We had $93.6 million available under our share repurchase authorization as of September 30, 2018, and our Board of Directors extended the expiration date on our repurchase plan to December 31, 2019.

Turning to the balance sheet and cash flows. Total unrestricted cash and short-term investments as of September 30, 2018, were $113.6 million. Restricted cash and cash equivalents were $61.7 million as of September 30, 2018, and represents the cash collateral on the credit agreement. As was mentioned earlier, GCE CapEx in the third quarter of 2018 was approximately $5.1 million or 3.3% of net revenue. We estimate GCE's annual CapEx could range between $10 million $15 million and be primarily software development and systems-related. We anticipate funding approximately $25 million of CapEx on behalf of GCU through the secured note in the fourth quarter of 2018 and $100 million in 2019. This funding is to finish the 2018/'19 school year project of 3 apartment-style residence halls and a parking garage for the 2019/'20 school year.

Last, I would like to provide color on the updated guidance we have provided for the fourth quarter of 2018. We have not adjusted our enrollment revenue or operating income in the fourth quarter from previously provided guidance as university enrollments are being impacted by higher-than-expected graduations. We now anticipate graduations will be 1,000 greater than expected for the year. Through the end of the second quarter, graduations approximated our expectations but have accelerated greater than expected in the second half of the year. Brian will provide more color on this in a few moments.

Revenue will be negatively impacted in the fourth quarter of 2018 due to the timing of GCU's fall semester start. We estimate interest income and interest expense will be $13.8 million and $700,000 in the fourth quarter, respectively. Interest income is primarily related to the seller financing. We've previously estimated that interest income would be $14.3 million in the fourth quarter, but due to timing differences in our funding of the university's capital projects, we have lowered our expectation. We now estimate our effective tax rate will be 21.7% in the fourth quarter, which is down from our previous estimate of 23.1% in Q4. Although we might repurchase additional shares during 2018, these estimates do not assume repurchases.

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

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

As President of GCU, I would like to say a few words on behalf of the university. Our traditional campus new incoming class was approximately 7,100 students. The average incoming GPAs of the new class was over 3.5. Our Honors College is now about 2,000 students with average incoming GPAs of over 4.1. We now have 11 advisory boards with over 200 companies, hospitals and school districts represented on those boards. There are now over 3,000 students involved in internships in the current school year. Our 9 colleges now offer 239 programs, certificates in emphasis areas. We are now up to 117 student clubs, have 547 students involved in theater, music and dance, have approximately 20 students involved in intercollegiate debate competition and anticipate over 10,000 students in intramurals sports, which includes over 1,000 students in Club Sports.

Our 21 Division 1 athletic programs won the Director's Cup in the Western Athletic Conference last year, and we expect to win again this year. We are currently at capacity in our residence halls. To support the growth on our traditional campus for the next year, we are building 3 new apartment-style residence halls, a new parking garage and a new Student Life Building. Our traditional total enrollment approximated our expectations. However, it's important to note that enrollment growth is being pressured by significant year-over-year increases in graduations. This is being caused not only by the recent growth in total enrollment but also due to the high percentage of our students that are graduating in under 4 years. This is the result of our expansive dual credit program with high schools across the country and students taking online courses during the summer. This is another reason that students and parents are attracted to the university. As we have discussed in the past, we anticipate that we will continue to see a decrease in the year-over-year growth rate in the spring semester of each year as new enrollments in spring have been fairly consistent year to year, primarily transfers, while fall to spring graduations continue to grow.

GCU's online student population growth is also starting to see pressure from year-over-year increases in graduates. As you will recall, online start growth accelerated during the second quarter of 2016. Significant numbers of those students started to graduate near the end of the third quarter of 2018, and a significant year-over-year increase in graduations has continued into the fourth quarter. I am extremely pleased with the new ground and online start growth. Because the quality of our students coming in continues to go up, the graduation rates which are listed on our website continue to go up.

It is also very important to note that according to The Institute for College Access & Success, GCU's graduates have less debt than the average state university student and far less debt than the average private university student. These facts, along which GCU's low cohort default rate, which we estimate will be 5.8% for our most recently completed cohort, makes GCU's value proposition to students and families very attractive.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Jeff Silber with BMO Capital Markets.

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

I'm just wondering post this transaction, if I'm either a student of GCU or an employee at GCU, have things changed it all for me?

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

If you're a student at GCU, no. The students on our crown campus, if you would have asked them before the transaction, if we were for-profit or not-for-profit, they probably couldn't have told you and don't really care. And absolutely nothing has changed for them post the transaction. The same thing would be true for online students. The things that they're happiest with are the high-quality of the programs, the tremendous amount of support that they get around the programs, the quality of the facilities, the classrooms, the laboratories, the electronic classrooms, all those things, and the fact that we haven't raised our tuition made it pretty affordable. If you're an employee, there were some slight changes, dealing with technology, e-mail addresses, things like that. There were some reporting changes. But in terms of the work that we're doing, on the behalf of students, the master services agreement clearly outlines that we keep the level of service up to our previous standards, and we are doing that. And so not much about their job has changed. As we move into becoming more aggressive in serving other universities, there will be some significant changes. But in terms of what's going on in the last 90 days, not a lot.

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

Okay, great. And let me just take a segue from that last comment. I know you said you'll give us more color on potential partnerships over the next few months. But I'm just curious, in terms of your initial discussions, where are you getting most traction and most interest in the type of services you offer? Is it providing online programs like traditional OPM? Is it providing some of the other services that a company like yours can provide?

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

It's definitely providing online services, universities wanting to get into that adult market and wanting to deliver their programs in an online format. The thing that attracts them a little bit more to us is the fact that a lot of universities or a lot of the OPMs shy away from the back-office services. We consider those to be very, very vital. The counseling services around scheduling, around schedule changes, around program selection, the processing of the financial aid work, the processing of the transcripts, building of schedules, those are all back-office functions that we have automated and can do very efficiently, which doesn't put the pressure on their internal systems that are not built to be able to handle that kind of scale. And as we've said before, we'll see how this all goes going forward. We're taking our time. We're very pleased with what we're getting out of Grand Canyon. I know a lot of you are interested in this, is there going to be a tailwind because of our not-for-profit status. We've seen a little bit of that in October -- in August, September and October. We're not making any predictions going forward except that we have seen a little bit of that, which is why we're taking our time and making sure that we find the right partners and one that we can build long-standing relationships with and that are mutually beneficial. Other than that...

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

Just one more quick question. In terms of GCU enrollment, are you no longer disclosing online versus campus?

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

Right. We are just -- we think it's probably more helpful going forward just to produce one number and keep that number -- yes.

Operator

Our next question comes from Jeff Meuler with Baird.

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

So obviously, a high-cost problem in terms of the increasing graduations. But I guess, are you just calling out the success that the university is having? Or are you trying to signal to us that there's a headwind building as it relates to enrollment growth at GCU online in 2019 that we should be cognizant of? And can you give us any just sizing of how big the step-up in graduations is if that's what you're trying to call out?

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

No, Jeff, I don't think there's anything to be hugely concerned with. I think we are a little bit surprised by how far graduations were over our original estimates for the year. We look at where we think students -- when students will graduate and use that to budget graduations. And as I mentioned, for the first half of the year, we were pretty much right on. In the second half of the year, especially the last 2 months, November -- what we've seen so far in November, October and a little bit in September, we've seen it really start to spike. So I think those large start groups, cohorts started in the second quarter of 2016 on have really kicked in for graduations now. So no, I don't think we're signaling any big shift in our long-term objectives for growth other than just to make sure everyone remembers about those large cohorts and factors that appropriately in their model as they look at enrollment growth for next year.

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

And just to add to that, there are 2 separate issues. The online issue we had the acceleration of those starts, which now we're getting a large cohort that's graduating. Fortunately, we've -- that's being offset by really strong start months. So echoing what Dan said, we don't think you can expect any significant downturn. On the ground side, it is. We have a very aggressive dual credit plan -- dual credit program with thousands of universities across the country, and students are earning dual credit either through us or other universities. They're bringing that credit in, and we're becoming a very attractive place because students are finding that they can go through their program in 3 years. They can add a second major, they can add a minor. And so the process that we're going through right now to counter that is to increase our new start budget for next year on the ground campus to offset that very positive thing. And it's such a strong thing to sell to parents that not only does the average student in our campus pay $8,600 year for tuition and $7,000 per room and board, but if you can graduate in 3 years, the value proposition is tremendous and the opportunity to graduate with little or no debt because you can work on campus is tremendous. And so we just need to use that to our advantage and accelerate the new starts on the front end.

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

Got it. And then I'm just a little confused, I guess, you don't have a defined adjusted EPS or something, so maybe that's why you're phrasing things this way. But just on this $1.06 EPS, excluding certain costs, I mean I get that the loss on transaction and the university expenses, which I think are related to the stock comp vesting are onetime in nature, but just trying to, I guess, compare guidance to prior -- or prior guidance to this $1.06 figure, the contribution made in lieu of state income taxes, why is there a big net income impact in the quarter? I would think that there would be an offset on the tax rate? Or is there something from a timing perspective in terms of you have expense this quarter but you get the benefit in the different quarters, something along those lines?

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

Yes. You might remember this, but we report -- we have to report 100% of the contribution as a general and administrative expense in the third quarter when we make the payment. We get $1 for $1 credit on that contribution, although we get 3 quarters of that $1 for $1 credit in the third quarter and 1 quarter in the fourth quarter. So it does have a slight -- not material but a slight impact on EPS because you're picking 100% of the expenses in the third quarter and 75% of the reduced tax expenses in the third quarter.

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

What's this $1.06 assuming?

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

The $1.06 is assuming that the contribution wasn't made at all. And so -- and again, I don't -- my guess is, I wouldn't focus a lot on that because I think, if you take it out or if you leave it in, I don't think it changes the $1.06 because you're talking about not a huge amount. Really, what gets you to the $1.06 from the reported EPS is the $22 million worth of transaction expenses that were recorded. But there's probably a $0.05 maybe in that contribution as well.

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

Okay. So the $3.7 million that you're showing in that line or you're describing, the $1.06, that's just the pretax amount. So on an after-tax per share basis, it's $0.01 or less?

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

To calculate it, $3.7 million is the expense within G&A, and then it's $2.9 million, which is the benefit that you're getting in tax -- at lower tax expense.

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

Okay. And then just, Brian, the comment on you're starting to see some tailwinds from marketing as a not-for-profit in recent months, could you just go into more detail there in terms of the marketing efficiency or other benefits that you're starting to see?

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

It's partly on the traditional ground side, which we won't see the impact of that really until next August. But there are school districts throughout the country that just wouldn't allow our counselors in to talk to students because we had a for-profit status. And so we expect a very strong new incoming class in August as a result of our abilities to get places where, in the past, we couldn't get. In terms of online, I wouldn't say it's so much the advertising efficiency as it is the conversion efficiency. We had very good start months in, we had good start months in August and September, which are difficult because they're big months, but then we came back with a very big month in October as well. We'll see if that extends for a long period of time. We just have no way of knowing -- when the higher education market is fairly flat or maybe there's a slight increase, for us to grow as we have in the last 10 years is kind of amazing. So we were able to overcome that for-profit status, which should be a positive thing, but in the minds of many, it's not. But the fact that we had these strong months recently without a huge additional extra spend is a little bit of a positive sign, and we'll see where that goes. We just have no way of knowing how many people historically just didn't pick up the phone because it was for-profit. And so we're going to watch, obviously, November and December and see how things look in January and February before we make the final assessment of what that tailwind might be.

Operator

Our next question comes from Peter Appert with Piper Jaffray.

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

So Brian, is it possible to get any more color in terms of sort of the tone of the discussions you're having with potential new clients? And any thoughts in terms of the timing of when you might be able to sign up this next -- first new client?

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

We hope that things happen in the next 3 or 4 months so that we would be ready to start in August or September of next year. We'll see how that goes. Again, we're taking our time, things are going well to develop Grand Canyon University. The tone is very interesting because you meet with well-branded institutions who have one foot in the old days in some of the measurements that are very important to certain of their faculty members, the number of applications that you reject, what your peers say about you, which is almost those 2 things combined 40% of the U.S. news and report rankings. On the other hand, those same universities are struggling tremendously with their discount rate because people just aren't willing to spend $50,000, $60,000, $70,000 a year to private university and grew $150,000 worth of dollars -- worth of debt to go back to school. And so this model, this high-brand model that we created has unbelievable efficiencies, which is tremendously disrupting the industry, especially for private universities. And so where do you want to play? Do you want to play in the past? Do you want to play in the future? Or do you want to play somewhere in the middle? So that is what they have to decide. There are so many fascinating things about what's happened the last 10 years here. If you ask our students on our campus and we're building that really, really strong student body with -- by virtue of average incoming GPAs, by a virtue of 60% studying at very difficult academic areas, engineering, computer science, information technology, biology, premed, et cetera, if you ask them if it matters to them that we have 70,000 working adults attending online, it doesn't matter to them at all that we have those students. It doesn't impact the brand negatively at all in their minds. In the past, keeping your brand -- keeping your population scarce to increase your brand would have been something people thought was very important. We're finding out that it's not important at all. And so the tone of the discussions -- in the tone of the discussions, you can feel the tension. Do you want to be a part of what was considered important in the past? Or do you want to be a part of what is -- what people are considering important going forward? I tell people all the time, when families come on our campus now, they have 3 big questions, which has really changed. One, do you have programs, academic programs, that my son and daughter can get involved with that are going to help them get a good paying job and access to a good career? That's really, really important to them. Secondly, can you help my son or daughter to graduate with a degree in a reasonable amount of time and with very little debt or no debt? That's very important to them. They don't want their kids traveling with $150,000 worth of debt. And then thirdly, is your campus safe? And is there some sense of moral or ethical standards that surround what you do? And when you can answer all 3 of those yes, a lot of the things that people thought were important in the past no longer become important. And so it's finding a partner that wants to keep what is best in the past -- and when you think about how we deliver education, we're very traditional. We teach with professors, we teach with small class sizes, we teach with a big focus on writing, critical thinking and problem solving. We get our kids involved in internships early on in their careers. So we're very traditional in how we deliver education. We're very nontraditional in how we build the university student body, create efficiencies and offer this at very reasonable costs. And so which part of that do you want to be part of going forward is the tension that people are experiencing. And it's interesting. And we think we'll find the right partner, but we want a partner who has a clear vision for what education should be in the future, not what it's been in the past.

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

Right, understood. And then I'm just wondering, this might be for Dan, if the economics of the business changed at all in the context of more students on this 3-year program, right? Because it could imply that the average revenue per student is lower, which could conceivably have negative implications from a margin perspective. How does that work, Dan?

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

Yes, as you look at the ground campus, yes, a lifetime value of the student might be less than what we had initially thought because they're graduating sooner. Now definitely the case with dual credit. Obviously, if they're taking online courses over the summer, we discount those courses -- or the university -- I'm sorry, the university discounts those courses. So when you add it all together, it's not maybe as big of a difference as what you might think. But there is no doubt that dual credit does reduce the university's lifetime value of the student a little bit. But the flip side is higher retention rates, higher graduation rates, which are all good.

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

The other part to that, Peter, that is important is that people ask me all the time, "Why are you building all these buildings, these residence halls, these classrooms, these laboratories as this things go on the way of technology moving forward?" and my comment always is, for traditional students, 18-year-old kids, the experience they get in this campus is more important in our opinion than it's ever been. It just has to be affordable. It can't be at $200,000 worth of debt. And so as we move forward, the percent of all of our students that come into the traditional campus and live on the campus, which more than doubles the amount -- well, doubles the amount of revenue that we get per student, it was going to help offset that 3 years. And so when students commute, we get on average $8,600 a year. But when students live on campus, it's closer to $16,000 a year. And the margins on the residence halls, even though we charge 1/3 less, are huge. And so that -- the 3 years is partially offset by the amount of revenue we get for the kids who are living on campus.

Operator

And I'm not showing any further questions at this time. I'd like to turn the conference back over to our host.

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

We have 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 Dan Bachus. Thank you very much.

Operator

Ladies and gentlemen, that concludes today's presentation. You may now disconnect and have a wonderful day.