11-December-2008

Grand Canyon Education (LOPE)

Provides online degree programs in education, business and healthcare.

Investment Rating: Marketperform

Stock Data

Current Price (11-Dec-2008)	$14.67
Shares Outstanding	43,559,714
Market Capitalization	$639,021,004
Enterprise Value	$629,596,004

IPO Data

Offer Date	11/19/2008
Offer Price	$12.00
Price Range	$16.00 - $18.00
Shares Offered	10,500,000
Use of Proceeds	Insiders

IPO Underwriters

Credit Suisse	Merrill Lynch
BMO Capital Markets	William Blair
Piper Jaffray	

Key Financial Data

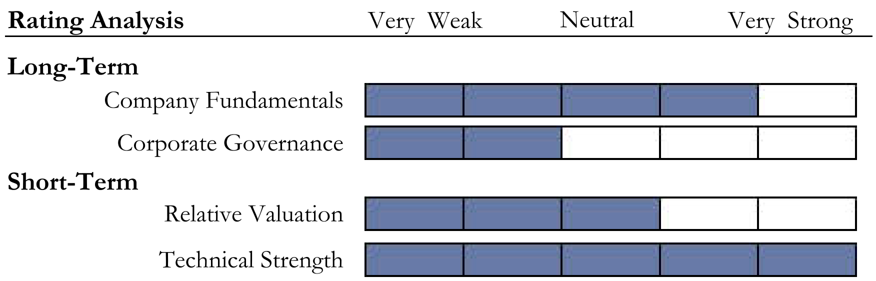
Income Model			*FY Ended Dec*
($ in mil)	**2007A**	**2008E**	**2009E**
Sales	$99.3	$155.9	$222.5
EBITDA	$11.4	$20.5	$47.2
EPS	**$0.15**	**$0.11**	**$0.48**

Balance Sheet	*As of 9/30/08 (adj. for IPO)*
Cash	$42.0
Working Capital	$12.5
Total Assets	$121.0
Total Debt	$32.6
Shareholders' Equity	$42.4

Corporate Data

Employees	2,237
Year Founded	1949
Headquarters	Phoenix, AZ
Phone Number	(602) 639-7500
Web Address	www.gcu.edu

Rating Analysis



Investment Thesis

Formed in 1949 as a Baptist college, Grand Canyon University fell upon poor financial footing in the late 1990s, and a group led by the current chairman rescued the school from near bankruptcy in 2004. The team converted it into a for-profit institution and outlined a plan to expand its online degree programs. With expertise in the education, business and healthcare fields, the university now has 22,000 students (88% online), and its recent sales initiatives have driven enrollment growth. The company lured the former head of Apollo Group to takeover as CEO earlier this year, and hopes to capitalize on the rapidly growing online postsecondary education market as more adults realize the convenience and benefits of an online education.

Rating Rationale

Grand Canyon priced 10.5 million shares at $12, a 29% discount to the midpoint of its original range of $16 to $18. The stock broke its IPO price on the first day, however, it has since traded steadily higher to the $15-$16 range. We attribute the stock's impressive performance to strong investor interest in the counter-cyclical education sector as a weakened economy has driven higher student enrollment, better retention rates and lower advertising costs for the company's peers. Furthermore, we believe in Grand Canyon's long-term growth potential given its focus on three of the most popular disciplines and its scaling profitability. However, these positives seem to be already baked into the stock as the company is currently trading in-line with the average forward earnings multiple of its closest comparables (30x) and thus we initiate our coverage of Grand Canyon with a marketperform investment rating.

Bull Insights

- Has delivered impressive and accelerating enrollment growth since 2005
- The online education market is growing at 30% per year
- Has a scalable online business model with good revenue visibility
- Focuses on three of the most popular subjects: education, business, healthcare
- The education stocks are countercyclical

Bear Insights

- Operates in a competitive market and lacks strong brand recognition
- Surging sales and marketing expenses have weighed on margin expansion
- The executive team has only been in place since July 2008
- The proposed valuation is rich relative to those of its online education peers

For important disclosures, please refer to the end of this report.

Latest Results and Outlook

Recent Financial Trends

For the nine months ended September 30, 2008, total revenue increased 60% to $109.6 million as 62% enrollment growth and higher tuition fees more than offset a $5.3 million increase in awarded scholarships. Gross margin improved 650 bps to 66.3% as a result of a mix shift to its online degree offerings while its operating margin, excluding royalties paid to the former owner, improved less as surging sales and marketing expenses more than offset the gross margin improvement and increased leverage on corporate overhead.

Outlook:

Despite softness in the US economy, we expect online education enrollment growth to continue as more employers require advanced degrees and people realize the convenience of an online degree program. Thus, our model assumes 4Q08 revenue of $46.3 million (50% growth) for a full year total of $155.9 million (57% growth). We then expect sales growth to decelerate to 43% in 2009 and 36% in 2010. Grand Canyon's gross margin has benefited significantly from the mix shift to online degrees, and we predict a full year gross margin of 67.1% in 2008 followed by slow expansion to the 70% level over the next several years. We also expect that the company will gain significant operating leverage beginning next year when it starts to absorb its sales and marketing expenses, and we estimate that operating margin will expand beyond 20% by 2011. Our model assumes earnings of $0.11, $0.48 and $0.89 per share in 2008, 2009 and 2010, respectively.

Interim Results - *3 months ended*

($ in mil)	Sep-07	Dec-07	Mar-08	Jun-08	Sep-08
Sales	$24.4	$30.9	$35.7	$34.6	$39.4
Gross Margin	59.1%	62.7%	67.5%	64.1%	67.0%
EBITDA Margin	6.9%	14.0%	19.5%	2.5%	10.7%
Operating Margin	3.5%	10.8%	19.5%	2.5%	7.1%
Net Margin	2.4%	7.1%	12.1%	1.1%	3.5%
EPS	**$0.02**	**$0.06**	**$0.13**	**$0.01**	**$0.04**
Cash Flow Data					
D&A/Non-Cash	$0.8	$1.0	n/a	n/a	$1.4
CFFO	$8.4	-$5.1	n/a	n/a	$19.4
Less: Capex	$1.9	$2.3	n/a	n/a	$2.0
Free Cash Flow	$6.5	-$7.4	n/a	n/a	$17.4
Operating Metrics					
Sales Growth	39%	41%	54%	66%	61%
Enrollment	13,499	14,754	17,486	16,510	21,957
Enrollment Growth	32%	38%	53%	60%	63%
Student Breakdown					
Graduate	64%	62%	n/a	61%	56%
Undergraduate	36%	38%	n/a	39%	44%
Online	84%	85%	n/a	90%	88%
Classroom	16%	15%	n/a	10%	12%

Interim Results - *9 months ended*

($ in mil)	Sep-07	Sep-08
Sales	$68.5	$109.6
Gross Profit	$40.9	$72.6
EBITDA	$5.6	$12.0
Operating Income	$4.8	$10.6
Net Income	$3.1	$6.1
EPS	**$0.09**	**$0.19**
Margins		
Gross Margin	59.8%	66.3%
EBITDA Margin	8.2%	11.0%
Operating Margin	7.0%	9.7%
Net Margin	4.5%	5.6%
Cash Flow Data		
D&A/Non-Cash	$2.3	$3.7
CFFO	$12.2	$18.1
Less: Capex	$5.1	$6.0
Free Cash Flow	$7.1	$12.1

Balance Sheet Data	Actual	Post IPO
($ in mil)	9/30/08	9/30/08
Cash	$22.8	$41.7
Working Capital	-$6.8	$12.1
Total Assets	$106.1	$125.0
Total Debt	$32.6	$32.6
Shareholders' Equity	$25.8	$44.7

Company Fundamentals — Rating: Strong

While Grand Canyon is up against stiff competition, the online education industry has enormous growth potential and Grand Canyon's business model is very scalable. Also, the company specializes in three of the most popular disciplines and caters to an older student population, which translates into higher retention and completion rates, and thus better financial results. Key risks include its high sales and marketing expenses, high bad debt expense ratio and ongoing litigation, the outcome of which could prove detrimental to its financial results.

Business:

Provides postsecondary degree programs in education, business and healthcare to 22,000 students through its online course offerings (88% of enrollments) and traditional campus in Phoenix, AZ (12% of enrollments). Offers 82 academic degrees through its College of Education, College of Nursing and Health Sciences, College of Liberal Arts and the Ken Blanchard College of Business. 56% of total students and 60% of online students are enrolled in graduate programs. Caters to an adult/working professional population and 92% of online students are age 25 or older. Tuition costs $47,000 for a four-year online undergraduate degree and $15,000 for an online graduate degree. Online tuition fees increased approx. 5% for the 2008-09 school year. Employs 460 ground-based faculty members (53 full-time) and maintains a pool of 1,000+ online faculty members, of which 656 have taught at least one class in 2008. Its online faculty members receive special training and are assessed with peer reviews by full-time ground faculty. Online classes are small in size: none have more than 40 students and 90% have fewer than 25. Also offers its programs on-site at the facilities of certain employers; has direct billing arrangements with 28 employers covering 2,100 employees. Launched 17 new online programs in 2007 and 12 year-to-date. Employs 550 recruiters at facilities in AZ and UT, and plans to add up to 150 more recruiters by the end of 2009. Marketing channels include online advertising, seminars and recruiting events. Derived 70% of 2007 revenue from government-sponsored financial aid (Title IV) and 5% from private loans.

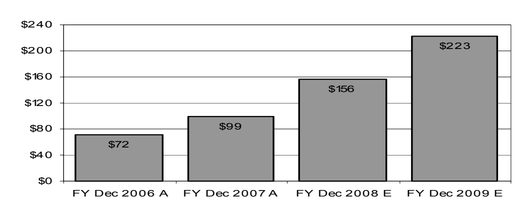
Competition:

Competes for enrollments with the more than 4,000 traditional US colleges and universities, many of which now offer online degree programs. Other online universities are Capella University, University of Phoenix, Walden University and American Public Education's American Public University and American Military University.

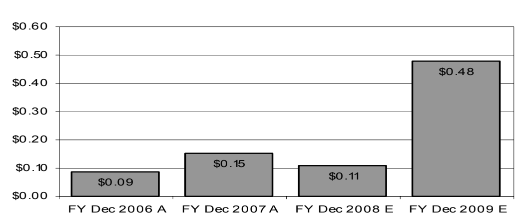
Risks:

Operates in a highly regulated industry. Is party to two ongoing lawsuits: the Department of Education is investigating its enrollment officers' compensation practices and the company is accused of fraudulent practices that would have made it ineligible for Title IV funding. Relies heavily on Title IV funding (70% of 2007 revenue); failure to meet the financial requirements or a decrease in Title IV loan availability could have a material impact. Furthermore, interest rate hikes that increase educational costs could curtail demand for its program. Is spending heavily on sales and marketing (40% of LTM revenue vs. 28% in 2006). The business is seasonal with weak enrollments during the second quarter. Has a high bad debt expense ratio (4.8% YTD). Cited material weaknesses in its internal controls over financial reporting.

Annual Sales Trend



Annual EPS Trend



Income Statement Data

FY Dec ($ in mil)	2005	2006	2007
Sales	51.8	72.1	99.3
Gross Margin	45.8%	56.6%	60.7%
Operating Margin	-6.3%	7.9%	8.2%
Net Margin	-5.1%	4.5%	5.3%
Cash Flow Data			
CFFO	-7.0	6.8	7.1
Less: Capex	0.8	2.4	7.4
Free Cash Flow	-7.8	4.4	-0.3
Operating Metrics			
Enrollment	8,422	10,662	14,754
Enrollment Growth	n/a	27%	38%
Student Breakdown			
Online	74%	79%	85%
Ground	26%	21%	15%

**All financials in this report exclude the royalty paid to the former owner.*

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Corporate Governance — Rating: Weak

The major positive with the corporate governance picture is that the executives were specifically brought in for their public company experience at Apollo Group, where current CEO Brian Mueller successfully scaled the largest online education provider, University of Phoenix. The downside is that the team has only been together since July 2008. Furthermore, only two of the six directors are independent and executive compensation appears high relative to the other online education companies. Our largest knock on the governance is that 75% of the offering proceeds was used to pay a special distribution of $94.5 million to insiders. Furthermore, Brent and Christopher Richardson, who serve as the Chairman and General Counsel, respectively, possesses over 40% of the voting power pursuant to a voting agreement with two smaller shareholders and their sister. There is also a related party transaction with Mind Streams, which is owned by the Richardsons' father; Grand Canyon has paid Mind Streams $4.3 million so far in 2008 for student referrals.

Key Executive	Age	Position	Corporate Background
Brian Mueller	55	CEO	Since July 2008. Worked at Apollo Group from 1987 to 2008, most recently as President. Also was COO and then CEO of the University of Phoenix Online (Apollo's online unit) from 1997 to 2005.
Daniel Bachus	38	CFO	Since July 2008. Served as CFO of real estate developer Loreto Bay from Jan. 2007 to July 2008 and as Chief Accounting Officer and Controller of Apollo Group from 2000 to 2006. Worked at Deloitte & Touche for eight years before 2000.
Brent Richardson	46	Chairman	Since July 2008. Spearheaded the acquisition of the university along with his brother, the firm's General Counsel. Served as CEO from 2004 to July 2008. Was CEO of online education company Masters Online from 2000 to 2004.

Key Shareholder	Holdings	Additional Details
The Richardson Family	24%	Brent is Grand Canyon's Chairman and Christopher is the General Counsel and a director. Also includes the sister's 8% ownership. Each sibling received $10.4 million from the special distribution upon the IPO. Brent and Christopher control the voting rights for their sister and smaller shareholders 220 GCU and Significant Ventures, giving them more than 40% of the voting power.
Endeavour Capital	22.5%	A Portland, Oregon-based private equity firm. Holds two Board seats. Has invested $36 million since 2005 and recouped $28.5 million from the special distribution.
220 GCU	16.2%	An Austin-based investment firm. Invested $3.25 million in 2005 and received $20.1 million through the special distribution. Allocated its voting rights to the Richardson brothers.
Significant Ventures	6.7%	A Solana Beach, CA-based venture firm. Received $7.6 million from the special distribution.

Relative Valuation — Rating: Neutral

Grand Canyon is trading in-line with the 30x average forward earnings multiple of its closest peers APEI, CPLA & STRA. We believe CPLA (26x) and STRA (29x) are the most comparable given their focus on similar subject verticals, end markets (i.e. working adults) and sources of revenue (namely Title IV funding and corporate reimbursement). While LOPE is growing significantly faster than both CPLA and STRA we believe this growth should be discounted given it is at an earlier stage of development and carries a short track record under current management. And even though LOPE is trading at a discount to APEI, the most analogous comparable on a growth basis, we believe this is justified given APEI's lower risk profile and superior margins since it receives most of its enrollment from the military. We note that our 5-year DCF analysis, which assumes a 5-year sales CAGR of 35%, operating margins expanding to the mid-twenties by 2012 and a cost of equity of 13.5%, implies 50% upside, based on a 20x target earnings multiple. Even though the group has proved to be counter-cyclical thus far, given the uncertainly surrounding the student lending environment and unemployment, we believe investors should focus on the relative valuation.

Comparable Financial Analysis

IPO and Key Peers	*FY*	*Sales*	*GM %*	*EBITDA %*	*EBIT %*	*Net %*	*Debt-to-Capital*	*MRQ Growth*	*SG&A-to-Sales*
Grand Canyon Education	**Dec**	**$140.5**	**65.5%**	**12.7%**	**9.9%**	**5.9%**	**42.2%**	**61%**	**56%**
American Public Education	Dec	96.9	58.6%	28.8%	23.3%	14.6%	0.0%	56%	31%
Capella Education	Dec	260.5	55.2%	20.6%	14.0%	10.3%	0.0%	17%	41%
Strayer Education	Dec	371.1	66.4%	36.8%	31.4%	20.5%	0.0%	25%	35%
Apollo Group	Aug	3,140.9	56.4%	28.1%	23.9%	15.2%	18.8%	16%	32%
ITT Educational Services	Dec	966.0	61.6%	34.3%	31.4%	19.5%	53.3%	17%	30%
DeVry Inc	Jun	1,145.2	54.4%	19.4%	15.3%	11.7%	17.2%	21%	39%
Corinthian Colleges	Jun	1,110.7	41.0%	9.6%	4.4%	2.2%	11.2%	18%	36%
Career Education	Dec	1,716.1	61.6%	9.4%	3.9%	2.2%	1.3%	-5%	52%
Learning Tree International	Oct	181.3	57.6%	13.9%	9.8%	7.6%	0.0%	0%	43%
Lincoln Educational Services	Dec	359.9	58.6%	14.2%	8.7%	4.7%	5.8%	16%	50%
Group Average			**57.1%**	**21.5%**	**16.6%**	**10.8%**	**10.8%**	**18%**	**39%**

Note: All dollars are in millions. All financial metrics are based on LTM data; return metrics are based on forward estimates.

Comparable Valuation Analysis

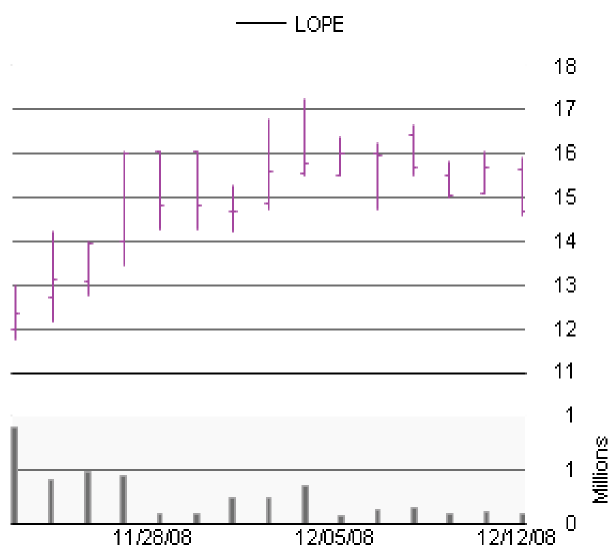
IPO and Key Peers	*Ticker*	*Price*	*Market Value*	*Enterprise Value*	*EV/Sales 2008*	*EV/Sales 2009*	*EV-to-EBITDA 2008*	*EV-to-EBITDA 2009*	*P/E 2008*	*P/E 2009*	*LT Growth*	*P/E/G 2009*
Grand Canyon Education	**LOPE**	**$14.67**	**$639**	**$630**	**4.0x**	**2.8x**	**30.6x**	**13.3x**	**133.5x**	**30.6x**	**35%**	**0.9x**
American Public Education	APEI	$39.73	$749	$708	6.7x	4.7x	24.6x	16.8x	48.5x	33.7x	35%	1.0x
Capella Education	CPLA	$53.34	$911	$797	2.9x	2.4x	15.2x	12.4x	32.8x	25.9x	26%	1.0x
Strayer Education	STRA	$204.17	$2,907	$2,790	7.0x	5.6x	20.3x	16.5x	36.0x	29.1x	19%	1.5x
Apollo Group	APOL	$73.53	$12,196	$11,519	3.5x	3.1x	13.4x	11.1x	24.6x	20.0x	15%	1.3x
ITT Educational Services	ESI	$84.35	$3,306	$3,169	3.1x	2.7x	9.3x	8.3x	16.9x	14.8x	17%	0.9x
DeVry Inc	DV	$53.06	$3,850	$3,822	3.1x	2.4x	16.2x	12.9x	27.4x	21.1x	20%	1.1x
Corinthian Colleges	COCO	$15.92	$1,382	$1,406	1.2x	1.1x	12.9x	8.6x	32.5x	20.9x	25%	0.8x
Career Education	CECO	$17.92	$1,607	$1,110	0.6x	0.7x	7.0x	6.1x	35.1x	22.7x	12%	1.9x
Learning Tree International	LTRE	$9.09	$151	$80	0.4x	0.4x	3.3x	3.1x	11.1x	10.1x	10%	1.0x
Lincoln Educational Services	LINC	$13.35	$345	$349	0.9x	0.8x	6.8x	5.9x	18.5x	15.3x	17%	0.9x
Group Average					**3.0x**	**2.4x**	**12.9x**	**10.2x**	**28.3x**	**21.4x**	**20%**	**1.1x**

Note: All dollars are in millions except for per share amounts.

Technical Strength Rating: Very Strong

Grand Canyon, the first US IPO since Rackspace's on August 8th, broke the longest IPO drought since the 1970s. While it was forced to price at a heavy discount to its original range, LOPE quickly shot up 33% to reach a high of $16 on November 26 and has remained around that level, making it the best performing IPO year-to-date. The sector has seen positive institutional money flow as investors have chosen to focus on company reports of strong enrollment figures, higher-than-expected retention rates and lower advertising costs instead of a tightening student funding environment. The sector has also largely proved to be countercyclical, which has kept investors interested in the space.

Stock Performance of IPO and its Peer Group



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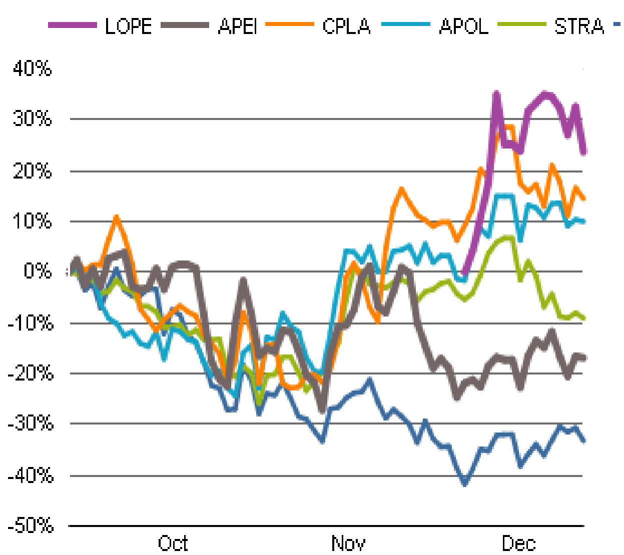
IPO Performance Data

IPO Price	$12.00
First Day Close	$11.85
Current Price	$14.67
First Day Pop	-1%
Aftermarket Return	24%
Total Return	22%
Average Trading Volume (30-day)	525,531
Days to Lock-Up Release	158
Shares Available for Sale	32,574,650
Percent of Total Shares Outstanding	75%

LOPE vs Key Publicly-Traded Peers vs Index



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Publicly - Traded Peer Group

Key Peers	*Ticker*	*Stock Price*	*Rel. Price Strength*	*Inst. Money Flow*
American Public Edu.	APEI	$39.73	Very Strong	Very Weak
Capella Education	CPLA	$53.34	Very Strong	Very Strong
Strayer Education	STRA	$204.17	Very Strong	Neutral
Apollo Group	APOL	$73.53	Very Strong	Strong
ITT Educational	ESI	$84.35	Very Strong	Strong
DeVry Inc	DV	$53.06	Very Strong	Strong
Corinthian Colleges	COCO	$15.92	Very Strong	Very Strong
Career Education	CECO	$17.92	Very Strong	Strong
Learning Tree Int'l	LTRE	$9.09	Strong	Strong
Lincoln Educational	LINC	$13.35	Very Strong	Strong

Stock prices as of 12/11/08.

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Outperform	26%
Marketperform	69%
Underperform	5%

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