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LRN - Q3 2020 K12 Inc Earnings Call

EVENT DATE/TIME: APRIL 27, 2020 / 9:00PM GMT

THOMSON REUTERS

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PRESENTATION

Operator

Greetings and welcome to the K12 Third Quarter Fiscal 2020 Earnings Conference Call. (Operator Instructions) As a reminder, this conference is being recorded. It is now my pleasure to introduce your host, Mike Kraft, Head of Investor Relations. Thank you. Mr. Kraft, you may begin.

Mike Kraft - *K12 Inc. - SVP of Corporate Communications*

Thank you, and good afternoon. Welcome to K12's third quarter earnings call for fiscal year 2020. Before we begin, I would like to remind you that in addition to historical information, certain comments made during this conference call may be considered forward-looking statements. These statements are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. They should be considered in conjunction with cautionary statements contained in our earnings release and the company's periodic filings with the SEC. Forward-looking statements involve risks and uncertainties that may cause actual performance or results to differ materially from those expressed or implied by such statements. In addition, this conference call contains time-sensitive information that reflects management's best analysis only as of the day of this live call. K12 does not undertake any obligation to publicly update or revise any forward-looking statements.

For further information concerning risks and uncertainties that could materially affect financial and operational performance and results, please refer to our reports filed with the SEC. These reports include, without limitation, cautionary statements made in K12's 2019 annual report on Form 10-K. These filings can be found on the Investor Relations section of our website at www.k12.com.

In addition to disclosing financial results in accordance with generally accepted accounting principles in the U.S., or GAAP, we will discuss certain information that is considered non-GAAP financial information. A reconciliation of this non-GAAP financial information to the most closely comparable GAAP information was included in our earnings release and is also posted on our website.

This call is open to the public and is being webcast. The call will be available for replay for 30 days.

With me on today's call is Nate Davis, Chief Executive Officer and Chairman of the Board; Tim Medina, Chief Financial Officer; and James Rhyu, President, Corporate Strategy, Marketing and Technology.

I'd like to now turn over the call to Nate. Nate?

Nathaniel Alonzo Davis - *K12 Inc. - CEO & Executive Chairman*

Thank you, Mike. Good afternoon, everyone, and thanks for joining us on our quarterly call. Such a challenging time for our country. I'm sure everybody is busy. But hopefully, you're safe and sound in your own studies as you listen to this call. I'm sure I join everyone on the call in saying that we continue to extend our thoughts and prayers to those impacted by this virus, both in the U.S. and around the world. The good news is times like this, they bring us together. Everywhere I look, I see goodwill and good intentions, people concerned about each other's health, both physical and emotional, and everybody coming together. It's wonderful to see a country coming together.

I'd like to get started with a brief summary of this quarter's financial results. Our new CFO, Tim Medina, will follow up with a more detailed comment.

As you saw in today's press release, revenue was $257.2 million in the third quarter of fiscal '20, an increase of 1.5% year-over-year. Our adjusted operating income for the quarter was $20.6 million, and capital expenditures for the quarter were $9.5 million.

Now looking at results in comparison to the guidance we provided last quarter. We beat our estimates across the board: revenue, adjusted operating income and capital expenditures. With limited impact from COVID-19 in these numbers, our results underscore the ongoing strength of our core business, and that's very important.

The underlying fundamentals of our core business remain strong. Now this is due in part to 3 factors. First, we saw student retention improve by 200 basis points versus last quarter. While some of this improvement relates to the impact of the pandemic, we saw improving retention trends even earlier in the quarter. Last quarter, I mentioned that we had implemented steps to help students determine if our program was right for them early on, and the effect of that would be to withdraw -- drive withdrawals up and retention down in second quarter fiscal '20, but would allow for lower withdrawals, better retention in third quarter and fourth quarter. It's also noting that we saw retention improvement in all grade levels and in most of the schools we serve.

Second, when getting guidance, on setting guidance in January, we anticipate a strong growth in new enrollment, and that happened as we internally planned. And third, customer satisfaction with K12-powered programs is increasing. Based on a recent parent survey, all satisfaction and loyalty metrics have increased from fall of 2018. Parent satisfaction with K12-powered schools and the curriculum rose to 82%. And the likelihood of those parents reenrolling their students topped 89%, both for all-time high.

More importantly, ratings on nearly all key drivers of net promoter score have improved year-over-year to 61, and this score puts us in line with other popular major national brands.

Importantly, in our press release today, we have reaffirmed the full guidance -- full year guidance we provided last quarter. And we often receive questions about COVID-19's impact on our business, both short and long term. I'd like to make some comments to answer that question. The pandemic has disrupted academic plans and goals for so many students across the U.S. and across the globe. All brick-and-mortar schools closed in the U.S., and it was a scramble by many to figure out just how does this virtual schooling thing work. However, the academic experience for most K12-powered programs is essentially school as usual. School as usual includes students with special needs and those in rural and underserved communities, just as the U.S. Department of Education has clarified in its guidelines. Also for the current school year, we do not anticipate changes in funding for public schools as a result of COVID-19. We've had communications with state authorities. We've monitored public statements by a number of policymakers. All indications are that schools we support will be funded, and as such, K12's revenue for fiscal '20 should not be negatively impacted for the services we provide.

However, for certain school functions being curtailed this year, the number of services we'll provide will be reduced. An example would be that we provide end-of-year testing in all schools that we support, leasing computers, assembling testing sites and things like that. While states have suspended end-of-year state assessment, so we cannot provide those services, and therefore, we cannot realize that revenue. You may have heard us talk about terms like this such as revenue capture in previous years. As such, revenues from these services will be somewhat lower than anticipated, and we therefore expect to achieve revenues for the full year at the lower end of our guidance range.

At the same time, the pandemic is also driving cost savings across our business. When coupled with our ongoing focus on cost reductions and efficiencies prior to the pandemic, we're realizing some cost reductions in a number of areas. Therefore, we anticipate achieving adjusted operating income at the high end or even possibly exceeding our guidance range for the full year. Now again, this is not a change in guidance, but just giving you more specific direction within the guidance we've already issued.

Let's talk about the upside of the pandemic in our business. As I've already said, it's horribly unfortunate for so many people all around the world. But we're in the business that helps schools and students in situations exactly like this. When the pandemic first started to impact brick-and-mortar schools, our phones begin to ring off the hook. And we saw a sharp increase in traffic on our website. We reached nearly 1 million unique visitors to the K12.com website in February and March, which is a 49% increase year-over-year. Many of those visitors built out lead submission forms. In fact, more than 100,000 lead submission forms were completed by parents in the last 2 months, a 57% increase over the same time last year. The majority of the inquiries we received related to families looking for options for students to complete the current school year. Most schools we support were unable to accept enrollments this late in the school year due to authorizer or local school board policies. However, for the schools that were open for enrollment during this period, we've received more than 6,000 applications, more than we had last year.

Now the impact of these students who were eventually enrolled, but it's not going to have a great impact on our revenue because they were enrolled very late in the school year. Some of the inbound inquiries, however, concerned options for the next school year. And while the enrollment season is just now starting, applications have already topped 14,000, which is a 16% increase compared to this time last year. Now at this point, no one knows how many of these applications will result in student enrollment in 2021 school year. However, we believe that some of these students will choose to stay with the program even if traditional schools open in the fall. And also, we hope some who expressed interest and investigated this choice for the spring will now choose online learning for the fall.

Our company has also stepped up in support of communities that were impacted by the nationwide school closures. This includes offering free online curriculum, platforms, training and technical assistance to students, their families and to school districts. We're also offering free webinars on best practices for teachers and families who have been thrust into an online environment for the very first time. To date, nearly 70,000 students, teachers and families have signed up for these programs and webinar. These efforts continue to raise interest in and awareness of the blended and online classroom and of K12's expertise in this area.

Lastly, we're also working closely with dozens of school districts on solutions that will help them educate students remotely. Some school districts are already using our curriculum under the 30-day free offer I mentioned. Others are using our supplemental content such as Stride and Big Universe. Many are using a mixture of both. So far, more than 30,000 students are being supported by these promotional programs in the current school year. We believe a larger, longer-term opportunity exists as districts figure out just how they will incorporate online learning into their regular curriculum and enter this full continuity plan.

Now I'd like to turn to Galvanize. As many of you may remember, we acquired Galvanize back in January. In their core immersive boot camp and enterprise businesses, Galvanize moved all programs fully online in mid-March. The good news here is that the majority of the students stayed with the program. While some have decided to defer until in-person sessions resume, students are committed to staying with Galvanize. We saw very few cancellations of new admissions or students dropping from existing classes. And in their community business, which manages co-working space in eight locations, Galvanize strongly encourages all team members to work from home and to follow CDC local health guidance. As you would expect, there are fewer new leases in the Galvanize community business given all the states have implemented work-from-home requirements. This caused the community business to stay flat in Q3 and will likely shrink a bit in the next quarter. None of us can predict when things will come back to normal, if ever, but when we'll see small businesses entering into more leases in the Galvanize community business.

But while the pandemic will be a headwind to Galvanize's community business in the short term, we do not feel it dampens the prospects of this total business over the long haul. In fact, the immersive boot camp business can be countercyclical during recessionary-like periods when people are looking to upscale or position themselves for new jobs when they've been laid off or out of work. The bottom line is we predict that Galvanize's boot camp and enterprise business can continue to deliver strong growth into fiscal '21. In fact, while the community business will not deliver against expectations, the consumer business is slightly exceeding our expectations at this time.

Before I leave my discussion of Galvanize, I also want to provide more detail on the impact of the acquisition on fiscal year '20 and fiscal year '21 financial results. As we mentioned last quarter, the adjustment to our operating income guidance for fiscal '20 was largely a result of purchase accounting related to the acquisition, $8 million to $9 million of the reduction in our adjusted operating income guidance related to Galvanize's negative operating income and to short-term operational investments we plan to make. But the remaining $11 million to $12 million was related to purchase accounting adjustments.

Specifically, all assets and liabilities on Galvanize's balance sheet, including deferred revenue, were required by accounting standards to be recorded at fair value. When deferred revenue is recorded at fair value, it has the effect of lowering revenue and profitability for the acquired business until the liability comes off the balance sheet. And I promise that is the last accounting list that I'll give today.

Overall, the gross prospects for Galvanize remains solid, and I'm confirming what I said last quarter. I expect Galvanize to deliver positive EBITDA in FY '21 and, therefore, be accretive to K12 EBITDA in FY '21.

So as we think about the impact that pandemic is having on our country and our communities, and I believe it to be horrific, it's a similar moment for online education. This moment will permanently change how the general public school district and regulators think about our business and how online education and blended education should be incorporated in the ongoing learning process. This is not just my personal opinion. This deal is informed by recent studies we commissioned with parents of students in the kindergarten to 12 grade. We asked them a series of questions regarding their views on online education in the post pandemic environment. This is what it's going to be after the pandemic is over. The results were eye-opening. 88% of parents agreed that online learning should be an option for families. In addition, more than 68% of the parents are either somewhat or very reluctant to send their students back to school with other students even after the pandemic subside. Prospective parents believe career readiness education is an important way for their children to learn real-world skills and be prepared for the future. More than 30% of high school parents want school options with online career readiness education offering. And while the short-term positive impact of the pandemic may be modest to K12's current financials, the long haul, the long term effect, we see providing a great tailwind to our business model.

Epidemic has crystallized 4 things for us. It's increased the awareness and acceptance of online options. It's helped break down the preconceived notions about online learning and highlighted the difference between a simple digital video session and a comprehensive online learning program with teaching and instruction and measurements. Third, it's made school districts examine their preparedness for disasters and highlighted how online learning can be and should be a part of their ongoing plan. And fourth, it's increased brand recognition for K12. We believe that over the long haul, these are all good trends for our business.

So in summary, our core business is strong, the underlying trends are improving and it shows to our results this quarter as we exceeded the guidance we provided.

I'll wrap up my longer-than-normal comment by talking about an important organizational change in K12. As you may have seen in our leadership organization released a few weeks ago, James Rhyu has now assumed a new role at K12 as President, Corporate Strategy, Marketing and Technology. For the past 7 years as CFO, James has helped implement my vision of our company. And more importantly, he shouldered added responsibility as President of Products and Technology while holding down the CFO job. That's a lot to ask of any one person. Now I personally hired James because in a previous life, I knew all about his work ethics, his intelligence, his skills beyond finance and his ability to help strategically drive innovation in any business he is involved with.

By every measure, he's been an instrumental part of our company's trajectory and a tremendous help to me personally. During his tenure, we've grown into a world-class education services company, and we've launched the company's interest into career learning and adult education market. I've asked James to help drive even more strategy, new strategy, marketing and technology expansions in a brand-new world. James will be partnering with me and leaders across the company to expand the market for K12, to reach new students, students who traditionally didn't or wouldn't consider online education from kindergartens to adult learners. He'll also lead the teams that drive the product innovation and improvements in the customer experience, all with the goal of attracting and retaining more students. He'll also develop the marketing and the messaging to support these new expansions. And he'll execute on mergers and acquisitions and partnering opportunities to support the growth strategy.

I'm lucky to have someone with his depth of experience ready to step in and help me increase shareholder value and provide great services to our students of all ages. James, thank you for your incredible contribution. I know you're leaving the finance organization and the financial health of K12 in great shape.

As I already mentioned, we are joined today by our new Chief Financial Officer, Tim Medina. Tim joins K12 with more than 3 decades of financial and capital markets experience, both domestically and internationally. He has an extensive background in accounting and operations, management and strategy and a deep understanding of high-growth technology sector companies, including important experience in acquisitions. He most recently served as Executive Vice President and Chief Financial Officer of TPx Communications. And prior to his role at TPx Communications, Tim served as CFO and in leadership positions at ECI Conference Call Services, Independent Wireless One Holding, Verizon Communications, GTE Corporation and CTI Holdings. I'm excited for someone with Tim's experience and background to join the K12 team.

So thanks, everyone, for your time today. And I'm going to turn the call over to Tim. He'll elaborate on the third quarter financial results. Tim?

Timothy J. Medina - *K12 Inc. - CFO*

Thank you, Nate, and good afternoon to our shareholders, analysts, employees and others who are joining us on the call today. I'm very grateful to Nate and the entire Board for this important opportunity. With so much change unfolding in our communities and our country, this is a unique time to serve as CFO for the market leader in online education. I'm proud to join the K12 team and our shared mission to provide a personalized learning experience for students of all ages and all backgrounds across the nation. I also am very excited about our opportunity to expand K12's leadership in the tech-enabled education market and helping lead K12's next phase of growth and value creation. I also look forward to getting better acquainted with all of you.

Now I'll quickly recap our reported results. Revenue for the quarter was $257.2 million, an increase of 1.5% from last year. Adjusted operating income was $20.6 million, a decrease of 24.3%. And capital expenditures were $9.5 million, largely flat to last year. As Nate mentioned, in each case, these results beat the expectations we provided in our guidance last quarter. Our core business continues to perform well, and the increased awareness of our virtual options positions us for accelerating growth over the long term.

Moving to our results for the quarter. Revenue for our Managed Public School Programs increased $5.7 million or 2.6% to $228.3 million. The growth in this business was driven by increased enrollments. Enrollments were up 2.2% year-over-year. Revenue per enrollment was largely flat, and we still believe that revenue per enrollment will be roughly flat for the full year. Institutional revenue in the quarter was $16.8 million, a decline of $4.5 million. This is in line with the trends we have previously outlined. Private pay revenues were $12.1 million, an increase of $2.8 million, mainly as a result of the Galvanize acquisition. As Nate mentioned, we believe that the Galvanize immersive boot camp and enterprise businesses will see positive trends in fiscal 2021, even in the current economic environment. The business is still targeted to be accretive to EBITDA in next year's financials.

Before factoring in the operational effects of Galvanize and $3.3 million of reductions in gross profit due to purchase accounting, gross margin would have been 32.8%. Reported gross margin, including Galvanize, was 30.4%, down from the second quarter. We expect full year gross margin to be 33%, plus or minus 100 basis points.

Selling, general and administrative expenses, excluding the Galvanize acquisition, were $59.5 million, down $2.2 million from last year. The acquisition of Galvanize added $4.2 million in SG&A costs in the quarter, including legal expenses from the acquisition. Reported SG&A expenses were $63.7 million. Even with the acquisition, we expect full year SG&A to be relatively flat to last year, plus or minus a couple of hundred basis points.

EBITDA for the quarter was $32.9 million. Adjusted EBITDA was $39 million, an improvement of $2.6 million before the effect of the Galvanize transaction. Operating income for the quarter was $14.5 million. And adjusted operating income was $20.6 million, an improvement of $2.6 million before the effect of the Galvanize transaction. The improvement in both adjusted EBITDA and adjusted operating income reflects improving trends in Managed Public Schools.

Some other items to note. We ended the quarter with cash, cash equivalents and restricted cash of $151.5 million, a decrease of $61.6 million compared to the second quarter. The decrease is largely the result of our all-cash purchase of Galvanize during the quarter, offset by a $100 million draw against our credit facility.

In response to the COVID-19 crisis, we borrowed against our existing credit facility as a preemptive measure. We continue to be in a very strong cash position, both short term and the fourth quarter and longer term in fiscal '21 and beyond.

Additionally, several states where we saw strong enrollment growth in fiscal 2020, like Texas, are states that typically pay all public schools after the school year ends. This may increase our accounts receivable balance and depress our free cash flow for fiscal 2020. However, I want to be clear that this is a timing issue only. We have closely and are closely following the policies of each state, and all have publicly committed to continue funding their schools. Based on this timing shift, we correspondingly expect stronger free cash flow in fiscal 2021.

Turning back to our results. Capitalized cost of $9.5 million for the quarter were relatively flat to last year. We continue to expect capital expenditures to be $45 million to $49 million for the year. Our effective tax rate for the quarter was 33.5%. We still expect our full year tax rate to be in the 28% to 30% range.

As detailed in our press release, we are reaffirming our full year guidance from last quarter. So for the year, we're looking at revenue in the range of $1.033 billion to $1.040 billion, capital expenditures of $45 million to $49 million. As just mentioned, a tax rate of 28% to 30%. And adjusted operating income in the range of $48 million to $52 million.

Now let me wrap up with a few final remarks. First, our core business is strong, and student retention and enrollments are both trending in a positive direction. Second, we have ramped our career readiness strategy at just the right time. In these turbulent economic times, students are looking for ways to ensure they have the right skills to enter or advance in the workforce. Both our Destinations Career Academies and Galvanize are uniquely positioned to support that demand.

Lastly, I want to reiterate that K12 is very well positioned to grow in spite of the uncertainty in the general economy. We are in a strong financial position and have a solid balance sheet with a strong cash position. States have committed to fund public schools during the crisis, and we are seeing increased demand for our services. We believe the effects of COVID-19 will be a lasting tailwind to online education and especially the K12's business model.

Thank you very much for your time today, and we'll now move on to our Q&A session. Operator, we're ready to begin Q&A.

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*

Thank you for the comments about the impact so far, potential impact going forward. I think in your prepared remarks, you mentioned that there was no -- or you didn't think there would be a funding impact for the current school year. Have you gotten into any indication about the upcoming school year for your fiscal 2021?

Nathaniel Alonzo Davis - *K12 Inc. - CEO & Executive Chairman*

Jeff, excellent question. This is Nate speaking. We have not gotten any negative or positive indications. So everything we've seen so far and everything we said is that the federal government wants to put more money in some of their early programs and some of the later programs they're now talking about, want to put more federal funds into education, so education doesn't stop. The states have said they want to continue education, and their economies are very dependent upon kids being in school and teachers getting a salary. So all the policymakers have talked about what they need to do.

Now we all know that's balanced by the fact that if they don't get taxes from citizens, then that reduces their budgets, and they got to take it out of transportation, health care or education or someplace. But so far, it looks like the federal government and the state governments are all motivated to get as much money into the education system as they can to keep it going. So we don't see any negative long-term impact today from what we know.

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

Okay. Great. That's helpful. Now I know it usually takes some lead time before you get permission to open up a new school, so I'm not assuming that anything that had not been in progress beforehand would -- I'm assuming anything you've had in progress beforehand will obviously continue. But has there been any indication that either you could ramp up a new school fairly quickly that you weren't thinking about beforehand or maybe get a cap raise on any state? Anything along those lines would be helpful.

Nathaniel Alonzo Davis - *K12 Inc. - CEO & Executive Chairman*

Yes. We have, Jeff. We have seen a couple of the -- not a couple. We've seen a number of the school board that we've been talking to. We've said to them, you really want to be in a position to be able to help students and help your community, help your state as more students want to be safe and want to be in online school. So a number of our partners have upped their cap so far, and we're talking to all of it. Anybody who has a cap, we're having a conversation with them about it. That issue probably will be resolved, all of them, within the next 60 days. All are having school board meetings over the next 60 days, and we'll be talking about it. We also see a couple of states who are opening their minds and beginning to talk to us about opening up schools where they weren't before.

And so without giving names because I don't want to put a legislator in a position that I've said something on an earnings call where they haven't worked at the state level, I can tell you that, yes, one of the reasons I made my comments that I think this is a positive tailwind is that we have seen states come to us and say, "Hey, can we do something here?" It remains to be seen that somebody will actually approve something in a short period of time, but that conversations are being had, for sure.

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

Okay. Great. That's helpful. And then just one more and then I'll go back in the queue. On Galvanize, you talked about -- I think you called it the consumer versus the community business. Can you just size up the different business sizes, what they have been and what you had expected beforehand?

Nathaniel Alonzo Davis - *K12 Inc. - CEO & Executive Chairman*

Yes. I don't know how much detail we've disclosed before, but the community business is slightly below $20 million. And I think it'll, as I said, shrink a bit. The community business is the largest business. It's over -- well over $20 million. And the enterprise business is the smallest business but the fastest-growing business.

Timothy J. Medina - *K12 Inc. - CFO*

Just to clarify that the community business was less than 20%. And then the remainder -- the enterprise business is smaller, and the remainder is the consumer.

Nathaniel Alonzo Davis - *K12 Inc. - CEO & Executive Chairman*

Sorry. I meant to say consumer on the segment. Too many C's.

Operator

Our next question comes from Chris Howe with Barrington Research.

Huang Howe - *Barrington Research Associates, Inc., Research Division - Senior Investment Analyst & Research Analyst*

As far as Galvanize, could you provide some color or clarity on what percentage of revenue or what percentage of enrollments was in online "boot camps" prior to the current environment where we saw the transition to online? And in light of that and in light of the current COVID-19 environment, I know you had mentioned positive EBITDA in fiscal year '21, but any change to your prior expectation for 2020 as far as Galvanize is concerned or any slight adjustments there?

James J. Rhyu - *K12 Inc. - President of Corporate Strategy, Marketing & Technology*

Yes. This is James. So to your first question on the online, before we acquired them, they were starting dabbling online, but less than 10% was really done online when we acquired them. The good news is that they were already on a trajectory to move more online, and they've accelerated that, and they've really shown, I think, great adoption with that. So I think they're on a really good trajectory to deliver their programs online on a continuous, ongoing basis. But also, when we get back to hopefully some sense of normalcy, they'll be delivering some blended and online versions. But I'd say trajectory is really nice there.

And your second question around just the financial projection for the year, I think as Nate said, certainly, their community business in Q4 will likely suffer the most, just for the obvious reasons that folks are less willing to go into offices. We don't see as much impact on their consumer businesses. Again, I think as Nate mentioned, that business is holding up fairly well and, if anything, is exceeding our expectations. And I would say on the enterprise business, they're probably a little bit below what our original expectation is. So net-net, predominantly driven by the community business are going to be a little bit lower.

Huang Howe - *Barrington Research Associates, Inc., Research Division - Senior Investment Analyst & Research Analyst*

Great. It's very helpful. And my next question, you mentioned applications were up, and you're seeing an increased overall level of interest as we head into the fall. Can you perhaps add some color as to any changes that you're making to the marketing strategy? I can imagine that given the current environment, your conversion rate should be increasing as we look forward to fall.

Nathaniel Alonzo Davis - *K12 Inc. - CEO & Executive Chairman*

That's true. We're seeing top of the funnel more and top of the funnel -- and we're seeing a better conversion rate now than we saw last year at this time. As you know, the conversion rate gets higher. Maybe you know. The conversion rate gets higher as you get towards into the enrollment season when parents are making their final decisions. But yes, we are seeing greater top of the funnel and greater conversion. These additional enrollments, what we expect to see is a lot of interest early in the season, and then we're going to see some of that tail off as schools open. So what's going to happen is as brick-and-mortar is open, some of the folks that are in the funnel right now will probably say, "Ah, my school is open,

I'll go back." But we don't think all of them will. Because as our surveys say, many of them are still going to be worried about, will I go back to school and put my kid in school where this virus is still going to be hanging around? So we expect to still see better performance and better conversions than we saw last year, but really can't predict what the absolute numbers are going to be.

James J. Rhyu - *K12 Inc. - President of Corporate Strategy, Marketing & Technology*

I think I would just add that from a macro trend perspective, what we're seeing in our schools, in our enrollment center, we see -- I think most of you know, a large portion of kids who come to the schools that we manage, they're sort of running away from something. And I think now, we see a lot of students, they're running towards us. They see us as a viable alternative. And from the long-term macro trend, I think, just building out awareness and viability of our product in a more mainstream way, I think that's going to carry over into the next few years.

Nathaniel Alonzo Davis - *K12 Inc. - CEO & Executive Chairman*

Also, in your comment about are we changing any marketing techniques, we'll have more -- 2 things we'll do this year. You'll see -- we'll have more digital and viral messages than we've ever had before, more YouTube messages, more Facebook messages. We've always done that, but we'll put more funds into that as a percentage of our overall spend than we've ever done before. And the second thing is we'll do a lot of joint marketing with organizations that have contact with school districts because we think school districts are going to want to do more with that. And then the final thing is there'll be a little bit more of what I would call image advertising this year than direct response. Direct response is when you put an add up, it says, call us now. Image advertising is a little bit more explaining to people what it does. Since the market is -- we think, is a little softer and more amenable to the message, we want to put a little bit more in there explaining to them what online is about because we think that will attract more people. Does that help?

Huang Howe - *Barrington Research Associates, Inc., Research Division - Senior Investment Analyst & Research Analyst*

It sure, does.

Operator

Our next question comes from Stephen Sheldon with William Blair.

Stephen Hardy Sheldon - *William Blair & Company L.L.C., Research Division - Analyst*

First here, within the increased number of applications year-over-year, can you talk some about what you've been seeing specifically for interest in career-readiness programs. I don't know if you get into that level of specificity with families this early, but what demand trends are you seeing for career readiness at this point?

Nathaniel Alonzo Davis - *K12 Inc. - CEO & Executive Chairman*

Well, we look at -- we do look at that level of detail, and there are 2 ways we look at the enrollment. One are the people who come to us because they're just interested in online, and then we talk to them about whether you want to be in a regular school or career-readiness school. And then there's another what we'll call funnel of folks who came to us just because they heard about Destinations Career Academies, which is our career-ready school. So we are seeing an increase in top of the funnel at Destinations Career Academies. We are seeing greater conversion than we've seen last year. That funnel is still not as big as I'd like it to be, and that requires us then, I think, to make sure our advertising is geared toward messaging to folks about what career readiness is all about. We still think there's a lot of market softening in a -- on a market messaging to let people know that these academies are available.

Now on the flip side, the folks who came to us just for online, and I'm not really thinking about career readiness versus NPS, we're having more conversations with them as well. And because we fleshed out more career pathways, that means more detail in IT, more detail in business and more detail in health care, we're able to talk to them better. So we're definitely going to see an increase in the amount of DCA enrollments this year than last year. I can't go beyond that because the season is not over, but I can tell you directionally, we are going to see more than we had last year. We already see that.

Timothy J. Medina - *K12 Inc. - CFO*

Yes, just -- I would add that we've run some early tests this season, specifically going after and targeting career-readiness students, and we're getting a lot of traction. So I think while sort of the overall halo around our business is strong, I think the specific actions we'll take and we'll continue to take through the summer around career readiness, early signs is it's going to drive a lot of traction.

Nathaniel Alonzo Davis - *K12 Inc. - CEO & Executive Chairman*

An example of that would be, if you looked at our Destinations Career Academies website for any school, if you looked at it a year ago, it had what I might call level 1 or 2 level of information. So you adapt to the second and third page and sort of reach the end of the message. Now it's much more fleshed out. There are examples of students there and more details about what the curriculum is like, more examples of what project-based learning is like. So there's more for the person who is investigating to understand about these academies are and, therefore, more interest.

Stephen Hardy Sheldon - *William Blair & Company L.L.C., Research Division - Analyst*

Got it. That's helpful. And then second here, just wanted to ask what is COVID-19 meant to your FuelEd business. I know you've been giving free trials for certain offerings, but have you seen any increased inbound interest from districts or charter boards to purchase ala carte services as they move their classes -- classrooms online? Could this be kind of a better environment for that business to maybe stabilize some as we look out over the next year or so?

Nathaniel Alonzo Davis - *K12 Inc. - CEO & Executive Chairman*

The answer is yes. We have. Our tiny sales force, which we had reduced in size, is now overwhelmed by the number of opportunities and the number of calls that they're getting on the inbound. I really wish the COVID situation was -- were over so they could travel because they are getting lots of requests for them to come present in school districts. So we are seeing more and more interest in that area. And not only for ala carte offerings, but also particularly for training their teachers in district schools and how to teach an online environment and how to put a full program in place, not just I want to buy your course.

To be honest with you, we're not seeing a dramatic increase, and I want to buy an individual course. We're seeing much more increase in I want to understand how to run a full program. They'll obviously do their own marketing because it's their students. But how do they train their teachers? How do they monitor the performance? How do they know the students engaging? All of those things that go with a full program, we're seeing a lot of requests and information about that. We're working with a number of private groups as well who have an inroad with many school districts. So think of the industry association for secondary principals, think of the associations for superintendents. We're trying to get in front of as many of those as we can, and we may be invited to give presentations there so we can talk about what our programs can do.

Operator

Our next question comes from Alex Paris with Barrington Research.

Alexander Peter Paris - *Barrington Research Associates, Inc., Research Division - Director of Research and Education & Business Services Analyst*

Most have been asked, but I have a couple, and this one kind of dovetails well with the last question asked. Within Managed Public Schools, as I recall, 2/3 are roughly charter school board and 1/3 are school districts. And these are -- you're actually running these online schools for school districts. These wouldn't be considered charter schools. These would just be considered a division of the school district, correct?

Nathaniel Alonzo Davis - *K12 Inc. - CEO & Executive Chairman*

That's correct. You have a great memory, Alex. Your numbers are right. About 2/3 are charter schools, and about 1/3 are district partnerships. And the district partnerships were the first ones that we went out to and said, "As a partner of ours, we're going to offer you free access to the content. And we'll talk to you about these programs that we can offer." So you're absolutely right, for the first part.

Alexander Peter Paris - *Barrington Research Associates, Inc., Research Division - Director of Research and Education & Business Services Analyst*

So as your top of funnel grows from consumers and that sort of thing, this is parents looking for online alternatives during COVID and then potentially beyond. The 1/3 of your contracts that are district partners, I would think this would have the -- COVID would have a bigger impact on these because if they have a license to do so, and they've not done so, this is not only an opportunity for them to grow their enrollment on a statewide basis, but also, they have a plan B in case another pandemic, God forbid, would come down the road.

Nathaniel Alonzo Davis - *K12 Inc. - CEO & Executive Chairman*

That's exactly right. And all of the large school district partners we've talked to were the first ones to sit down with us and talk about what should be their backup plan and how should they incorporate, how should they be ready to move easily from their 100% brick and mortar to a more blended kind of environment. So that -- those are the first people we did talk to.

Alexander Peter Paris - *Barrington Research Associates, Inc., Research Division - Director of Research and Education & Business Services Analyst*

Got you. And then -- I'm sorry, go ahead.

Nathaniel Alonzo Davis - *K12 Inc. - CEO & Executive Chairman*

I was going to say, and those are the ones that we're having the most success with because they know it's the best. Now what they're not doing, by the way, and you would expect them not to do this, is they're not saying, "I'm going to shift my student away from my brick and mortar completely over to that online program." Instead, what they're saying is, "Can I set up a separate online program for my -- for these kids in my district and a blended program for them?" So it's not so much that they're going to move them over to our 100% online program, it's talking more about a blended program.

Alexander Peter Paris - *Barrington Research Associates, Inc., Research Division - Director of Research and Education & Business Services Analyst*

For their constituents, that might be better suited for an online or a blended program.

Nathaniel Alonzo Davis - *K12 Inc. - CEO & Executive Chairman*

That's right.

Alexander Peter Paris - *Barrington Research Associates, Inc., Research Division - Director of Research and Education & Business Services Analyst*

Yes. Okay.

Nathaniel Alonzo Davis - *K12 Inc. - CEO & Executive Chairman*

Sort of an insurance policy. They want a continuity plan. You and I might think of it as a business continuity plan. So they're thinking about it as a business continuity, a school continuity plan. How would they continue if the school had to close down given they've already got us as a partner. So...

Alexander Peter Paris - *Barrington Research Associates, Inc., Research Division - Director of Research and Education & Business Services Analyst*

And I know you're giving a lot of free stuff away right now, which is the right thing to do as a good corporate citizen, but how would you charge for these plan B sort of schools? It wouldn't be the same as your typical district partnership.

James J. Rhyu - *K12 Inc. - President of Corporate Strategy, Marketing & Technology*

Yes. So Alex, the good news is, is that we've got tens of thousands of kids that are having access to our free programs now, and we're really happy with the traction we're getting and I think just the service that we're able to provide for the communities. I think, first and foremost, that's the most important right now. I think from a pricing perspective, a lot of our products have existing pricing structures. And so obviously, there's a starting point for that.

In terms of just, I'll say, the contingency planning that Nate talked about, I think the way we view pricing is a little bit fluid right now because we're not really sure exactly what's going to take hold in the marketplace. But our initial belief is, at least, is that, really, the clinical premium, if you think about it as an insurance product, should be fairly small, because what we're really trying to do is we're trying to build consensus in the marketplace that this is a viable product. And so we don't want to create pricing barriers just to have it on the shelf for, as Nate said, for a contingency type of basis. So really, the intent is really to have a very low barrier to entry to have it on the shelf for them.

Nathaniel Alonzo Davis - *K12 Inc. - CEO & Executive Chairman*

And Alex, you know that competitors listen to the calls, too, so I'm not going to disclose too much here. But I would tell you that we believe, and we have looked at pricing, we have set pricing tables that clearly make it -- that show a difference between small school districts and larger school districts. So the larger they are, the better rate per course that they get and the more ancillary services that they get. So -- and we've actually put that out to a couple of very large school districts. We had one what I'll call small to medium states ask us to bid on an entire statewide curriculum, and we haven't heard back from them yet. We had a very large city also ask us -- 2, actually. 2 large cities asked us to bid. And all of those, we looked at a volume discount kind of basis for how we price. So we've given a lot of thoughts to those things and have given those prices to those customers already, and we'll do so again next year.

We have -- by the way, I'd also mentioned, in 2 of those conversations, especially one with one of the largest cities, they asked us, first, what would it take, what price will we give in order to serve their students for the rest of the full year. We gave them a price. They came back and said, "Okay. Now tell me what that price would be if I was to use your content for a year or for 2 years." So we gave them a price for that as well. Now why am I telling you that? That only says that's how school districts are thinking. Their first response was, I got to get through this spring. What would you do for me this spring? But they quickly come back and say, "Oh, yes, I've got to think about next year because what if this happens again next year." So we begin to think about pricing for next year as well.

Alexander Peter Paris - *Barrington Research Associates, Inc., Research Division - Director of Research and Education & Business Services Analyst*

That's great. And then on the Destination Career Academies, can you refresh my memory? I think you had 6 stood up in fiscal '18, 13 stood up in fiscal '19, '20? Or it might have been '19, '20, '21. And first of all, what is your cadence for opening new DCAs? And has it changed or no?

Mike Kraft - *K12 Inc. - SVP of Corporate Communications*

Alex, this is Mike. We're still looking at about 3 to 5 new ones for fiscal '21.

Alexander Peter Paris - *Barrington Research Associates, Inc., Research Division - Director of Research and Education & Business Services Analyst*

And how many do you have right now?

Mike Kraft - *K12 Inc. - SVP of Corporate Communications*

20.

Alexander Peter Paris - *Barrington Research Associates, Inc., Research Division - Director of Research and Education & Business Services Analyst*

20 now. Okay. And then last question, and this is -- I was just thinking, with COVID, phones ringing off the hook, parents looking for alternatives for their kids. You weren't necessarily able to benefit from that given that enrollment was closed for most of the schools that you operate. Did you get any lift from your Private Pay Schools? Or did you have similar enrollment cutoffs?

Nathaniel Alonzo Davis - *K12 Inc. - CEO & Executive Chairman*

No, Private Pay was -- we got a very small lift there. We did get some, but we promoted a lot of it. We gave free access to Keystone for 30 days. We gave access to iCAD at a 50% discount. So we got some takes, but we had to discount it heavily. And again, the goal for us was to get exposure. We figured it was going to be late in the year. It wasn't going to be big revenue anyway. So why not just get more exposure and do the right thing for the community. So we didn't get a revenue list from Private Pay for that, but we did get more exposure.

Alexander Peter Paris - *Barrington Research Associates, Inc., Research Division - Director of Research and Education & Business Services Analyst*

Great. Congratulations on the quarter. Thanks for all the additional color.

Nathaniel Alonzo Davis - *K12 Inc. - CEO & Executive Chairman*

Thank you, Alex.

Operator

Our next question comes from Greg Pendy with Sidoti.

Gregory R. Pendy - *Sidoti & Company, LLC - Consumer Analyst*

Just one quick question. I think you said in the comments that -- and I could be mistaken, but selling and administration was just flat this year? And then if so, can you just kind of remind us? I think, last year, the cadence in the second half was kind of over-indexing in the fourth quarter. So just maybe how we should be thinking about that just overall into the end of 2020.

James J. Rhyu - *K12 Inc. - President of Corporate Strategy, Marketing & Technology*

Greg, sorry. We had some problem hearing you. Can you just repeat your question quickly? We couldn't hear you very well.

Gregory R. Pendy - *Sidoti & Company, LLC - Consumer Analyst*

Yes. Sure. So I think in your comments, you said that selling and administration to be flat year-over-year. And if so, can you just talk about how we should think about the cadence? I think last year, you had an abnormal 3Q and 4Q. I think you overspent in 4Q, if I'm not mistaken. But just kind of how should we think about that?

James J. Rhyu - *K12 Inc. - President of Corporate Strategy, Marketing & Technology*

Sorry. Yes. I got you now. So yes, you -- so if you look -- I think you're absolutely right. In Q4 of last fiscal year, our uptick in SG&A was a little bit abnormally high. We do normally have an uptick in Q4, though. So you will still see a seasonal uptick in Q4 as we start to get ready for the fall enrollment season, but it will be less than we saw in last fiscal year.

Gregory R. Pendy - *Sidoti & Company, LLC - Consumer Analyst*

Okay. And you're expecting that line item to be flat for the year? Or it was around 300 last year. Is that correct?

James J. Rhyu - *K12 Inc. - President of Corporate Strategy, Marketing & Technology*

Yes. I think we expect it to be flattish year-over-year.

Operator

Our next question comes from Steven Weber with Climbing Rose Capital.

Steven Weber;Climbing Rose Capital;Analyst

I know you've already gone over some of this, but could you just give a little more color? A lot of people have felt that the virus will return in the fall. And perhaps with people starting earlier than -- people going back earlier than we thought, the probability of that happening is higher. Just how that would all play out for you? If you can just give as much color on that as you could.

Nathaniel Alonzo Davis - *K12 Inc. - CEO & Executive Chairman*

Sure. Steven, we haven't talked before, but I look forward to meeting you one day. So unlike this spring, our schools will all be open for enrollment this fall. So any of those kinds of applications we get because schools are closed, we would be -- I'm sorry. Because the brick-and-mortar schools are closed, we would be able to take all of the applications. The only time we wouldn't be able to take them is when there is a cap by one of their boards, if the boards decided it doesn't want to take some of the -- but we have had those conversations with them and told them that our

recommendation is to do the right thing for the state and the right thing for the citizens in the state, which means opening up their caps and allowing more students in.

But in addition to that, states may even, and this is -- I think would be a big exception, I don't expect a lot of it to happen, but states might even open up schools quickly with providers like ourselves if they find that their schools are closed. But I think the biggest opportunity for us and for anybody, if, in fact, schools are not open and kids can't go back to school, it's going to be in the institutional business. That's where you would see us providing a program that they run themselves. We teach their teachers how to teach in an online environment, provide them the ability to enroll students in the curriculum of content and then let them go teach in that environment.

Now they've got to worry about how they get disadvantaged students in rural areas to get access to the Internet, how does everybody get a computer. They've got to solve some of those problems. But it's clear that if they're not able to go back to school, they're all going to have something. They're not going to let kids sit at home and do nothing. And they're going to want their teachers to be employed. And every state is going to want that for their economy. So we think the big opportunity is in training professional development of teachers who can learn how to teach in an online environment.

And I'll remind you that we developed an innovative program, the first of its kind in the country, with Southern New Hampshire University research-based studies and curriculum on how to engage kids and how to teach kids in an online environment. You can get a master's degree or you can get a micro certification in that. That's the kind of content and training we would take out to the market. And the second piece would be, once we've done that, helping them run that program. How do they, on an ongoing basis, monitor and do the data analytics and be in the content and curriculum. So I think if kids don't go back to school in the fall, you're going to see a tremendous focus on all the schools, putting those kinds of programs in place.

Steven Weber;Climbing Rose Capital;Analyst

So how in that scenario -- I'm sure you guys have sort of run models on the impact. How wide is a possible range of results, how much of an impact could that have on your finances if that scenario would unfold?

James J. Rhyu - *K12 Inc. - President of Corporate Strategy, Marketing & Technology*

Yes. It's James. I think for right now, we're trying to -- clearly, it's a large opportunity for us. We think it's a structural tailwind for us. We're actually not just for going to next year, but for many years to come. But we're really not prepared at this time to give any guidance around what the fall might look like. But it's certainly a large opportunity and we'll certainly accelerate growth into next year.

Operator

There are no further questions at this time. I would now like to turn the floor back over to Mr. Davis for closing remarks.

Nathaniel Alonzo Davis - *K12 Inc. - CEO & Executive Chairman*

Very engaging call. I really appreciate everybody asking questions and being engaged. It's probably our most engaging call. Forgive me for being longer winded than normal. I was longer winded today, but I thought you wanted to know about how COVID was impacting us. And I think Q&A proved you did want to know.

So with that, I hope everybody stays safe and you're following all the guidelines. Let's see if we can all get through this together. Thank you for your time today. Everybody, have a great day.

Operator

Ladies and gentlemen, this concludes today's teleconference. You may now disconnect your lines at this time. Thank you for your participation.