McGraw Hill Education

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Marlane Pereiro: Okay. Thank you for joining us. My name is Marlane Pereiro. I'm the high yield cable and media analyst at Bank of America. I'm pleased to have with us today from McGraw Hill Bob Sallmann and Danielle Kloeblen. Thank you for joining us today.

Bob Sallmann: Thank you.

Marlane Pereiro: Thank you. So just to start at a high level, you know, obviously, McGraw's been around for 137 plus years. So those who are not, as you know, close to the story. You know, can you share some key highlights from the company's evolution over the past decade?

Bob Sallmann: Yeah. And maybe I'll even go back a little further.

So over the last 20 years, you can see the evolution where we've moved to very digital oriented business. Today, we're nearly two thirds of our business is delivered digitally. And just ten years ago it would have been half that. So you can see that it's really accelerated to a digitally delivered content material.

And so what you'll see is that there's a platform in which we deliver our content. So rewind. When I was in school, I was lugging books around and you know, professors and educators would use those books and you have workbooks. All of that now is digitally delivered.

And so what we've started to see evolution towards is we've been leaning into machine learning for the last decade. And what that allows us to do is move towards a personalized learning experience for students. And now let's fast forward to where we are today, as that's evolving to utilizing AI. So we're leaning into AI and AI is really enabling the personalized learning.

And that's been the Holy Grail for education for the last hundred years. How can you do that? Because we can imagine a scenario, a classroom filled with 25 students, and all of those students have different learning capabilities, right? So we teach to the mean today.

But all of the students are in a different place and so now because they're using A.I. as a tool to help enable personalized learning, the outcomes will be radically improved. Additionally, what you're seeing is that the administrative burden on teachers today is overwhelming. And so we're utilizing technology to reduce the administrative burden on teachers as well to allow them to have more time directly with students.

So those are the areas that we continue to invest in, and we'll see further investment over time leaning into AI to help us. And then I would say the last place that we are leaning into AI, like other companies you hear from today, is, of course, driving efficiency in our organization. We spend significant money on content creation, and you can imagine our

ability to using AI to reduce the cost of content creation. So those are the three areas that you'll see us continuing to lean into over the future.

Marlane Pereiro: Great. And you know, looking ahead, what new capabilities will customers, i.e., students have on your platform, as you know, next year, even three years from now that they don't have today?

Bob Sallmann: Sure. Three weeks ago, we just announced launching some new products. And again, this would be a flavor of what you'll hear that McGraw Hill will continue to deliver over the next several years.

But the two new features we launched two weeks ago, three weeks ago, was in our K-12 business. And so we had an educator assistant, right, and think about a teacher creating lesson plans. So we had tools to help them enable lesson planning, which is, again, is that administrative burden on teachers. We also launched Writing Assistant.

And so the Writing Assistant, you know, think about this from my wife as a high school English teacher, you know, I demoed this product with her and we walk through it. But you can imagine the scenario the same 25 students. You have 50 minutes where the teacher is trying to help write essays with those students and the teacher, my wife, would be running around in the classroom trying to have that individualized education with those students.

So that's 2 minutes per student. What we've launched in our Writing Assistant is helping cue up those students so while they may not get that personalized teacher experience, they're actually having some personalized learning to help them continue. And most importantly, as we've developed this and again, our company has been around for 137 years, improving education is embracing the productive struggle.

And so by doing that, students still are challenged and cued in terms of not giving answers, but ultimately helping them think through like, how do I move to the next phase of my essay writing? So these are the kind of things that you'll see. Again, great examples of reducing the administrative burden for educators, as well as personalizing learning for students.

Danielle Kloeblen: And, you know, Bob, I'll just add the strength of the partnership with the educators and the institutions having that strong pulse read on exactly what they need and what they want is really critical and a strength of ours as well.

Marlane Pereiro: Great. And, you know, how do you see AI transforming the competitive landscape in education, you know, over the next 3 to 5 years?

Bob Sallmann: Yeah. And what I would start with is really our strengths. You know, brand is really, really important, as you can imagine. So we have a trusted brand.

Our red cube is known all over the world. And so we have that trusted brand that we can lean into. And so that is a differentiator when we think about, you know, as you hear all these startups and emergence of A.I. in education, what is our differentiation? The red cube, the brand goes so far, allows us to walk into any institution, any school district and start having those conversations. And our IP, right? And our IP isn't just that content we've been creating for 137 years. It's really the platforms as well.

So it's the combination of having the great content delivering it with platforms. But the key about the platforms is the data that comes off of that. So that's the third benefit is really thinking about we have 25 million paid digital users that are generating over 19

billion learning interactions every single year. So using all of that learning interaction and all those data points to start to inform that personalized learning that we had already talked about.

And lastly, we remain a very relationship-based business. So we have the longest tenured, the best reps in the industry and they deeply understand the educators' challenges, right? So what we're able to do is understand those educational challenges, use that insight and help us really further improve our product.

So while, you know, we'll hear about small Ed tech startups creating AI platforms, they lack sort of that brand, that reputation, the IP, all the data. And really it becomes almost an arms race where scale matters and because of our scale, we're in every district in America and, and, you know, talking to all of our, you know, all of the institutions, that scale really matters. And so I think we're really well positioned to improve and win in an ongoing AI advancing environment.

Marlane Pereiro: Great. You know, you've also talked about, you know, in the higher education market, your shares recently, you know, hit around 30%. That's up from about 21% a decade ago. You know, what have been the biggest drivers of that growth? You know, is it, you know, investment in digital, some of the products that you mentioned and also taking a step back, you know, how sustainable are these share gains given competition and emerging entrants, emerging AI first entrants?

Bob Sallmann: Yeah, and since I first got, you know, I think yeah, we've grown from 21 to 30% over the last several years. We're actually seeing our share gain accelerate.

So we grew 14% in the quarter year over year. Majority of that is through share gains. So we're continuing and taking share. And so why the question is, how come? What are we doing so great? Right.

So obviously our content, you know, we believe it is differentiated. There's really three large players in the higher education space. All of us have great content, again, very relationship based and we have deep relationships but with some of the innovation, and I think this is probably the bigger catalyst for what's changing it, we started introducing our new tools, our platforms. I think on every sort of survey we've tested out in the marketplace, our platforms support both the educator as well as the student. You always score the highest. We continue to invest in that. We've recently launched something called Evergreen, and this to me is really game changing and will further accelerate our share gains in the future.

So let me describe this for a moment. So think about your iPhone every day, every month, whatever it is, you get your iOS update. No big deal. You accept.

Well, what's different about the education space is you used to in higher education have an edition cycle, every 3 to 4 years you would have a new edition. And so what makes that important as you go out as McGraw Hill, is the new edition will come out, we go out and tell the professor how great the content is our addressing the relevant materials. But again, it might be two or three years old at that point, but that was also an inflection point for the professor. And the professor is now selecting different content.

So they say "that's all great. I really appreciate it, but I'm going to go look and see what the competition has out there." And at that point was when you would actually see turnover. And we knew it both when our competitors were being limited, launching a new edition, we would target those opportunities to go out and win.

So the reason why this is so important is now, first to market with this offering, Evergreen, which is effectively that professor is over 95% of the time hitting “accept”, meaning the latest and greatest content. So for, you know, an economics professor teaching about tariffs, it’ll have relevant real time information, but the beauty of what we've done is we've removed the edition cycle. And so the importance of this now is we no longer have to defend that, keeping that professor when we provide the new edition, but we're giving our sales force a time machine in a sense that they get to go out, and instead of focusing on retaining that professor and selling our latest edition, they get to go out and target takeaways.

So to me, that is really what's going to be the next accelerant for our further share gains going from 30 and well on beyond and I think that gives us long runway for the next several years to further capture share.

Marlane Pereiro: Great and you know inclusive access sales grew 30% year over year in the quarter. They're now roughly half of the, you know, revenue in the higher education.

How does this model, you know, strengthen retention, and share gains?

Bob Sallmann: Yeah, yeah, exactly right. Inclusive access is a delivery model that's available to all, all of our competitors. We've embraced it before others did.

We saw the economic benefit of inclusive access. And effectively what that is, is it's a channel in which students now get to purchase their courseware material through the university. So on the bursar bill they get invoiced, just like they would their tuition statement. But what's really happening? It allows the students to have materials day one. So obviously there's a benefit to the professor knowing that all the students have the exact same materials. It's available on day one. And for us and the benefit we see is that we have much higher sell through. So when I was a student, go back a long time ago at university level, you'd maybe have a third of students purchasing a new textbook. Now we're through the inclusive access model that's over 98%.

So you're having the high sell through. And the way the economics of that works is we have higher retention, greater sell through, but we're also offering a lower price point to the student. So inclusive access rolled out by the Department of Education requires us to have the lowest price point available to the student. So while we lower the price, we're getting greater sell through and greater retention.

So for us, the economics make lots of sense. You know, so we've embraced this of we're growing at a much higher rate than our competition because we see the merits and benefits for, it's a win win win for the institution, for the student and the professor. And the way the model works, and I'll just share with you sort of how we're growing our land and expand approach is we have about 2000 universities of the 4500 higher education institutions today using inclusive access, we're gaining about 100 institutions per year. Now, I don't think that we're ever going to say of the 4500 institutions, will they all be on inclusive access? Probably not. But there's a clear path that it could be, you know, 2500, 3000, somewhere up to the 3500 that we serve today.

So when you gain the 100 institutions, the first sale is actually a single professor. And so as we talk to that, professors say, hey, here's the merits of this program. Would you like to join? We actually will have a single professor at an institution come on board. That professor over time will tell his peers and the Department of Accounting and next thing you know, they're talking to their finance colleagues and then maybe economics professors and so it grows.

And so after the second to third and fourth year, you can go from one professor to 20 professors. And again, that is an accelerant for higher sell through. And then, of course, once they're in that program, it's easier to have all the students on it. We see much higher retention.

All of those things will continue to fuel growth. So we think there's a long runway there with inclusive access. And, you know, we're excited to continue to leverage that model.

Marlane Pereiro: Great. And which subject areas do you consider your strongest categories today and where are you most focused on?

Danielle Kloeblen: I can start . So I think, you know, we play everywhere, but some of our strengths is really the business economics and computing and in particular the business classes in the business schools. You know, top to bottom we cover all subjects and disciplines and that has grown over time to be really favorable in terms of enrolled students, social sciences as well. And then we have some really interesting things that we're doing with science.

Anatomy and physiology, a digital lab, which is really compelling. So lots of opportunities there as well as some new offerings, calculus being one of them, an area that, you know, we see as an opportunity to further expand our TAM.

Bob Sallmann: One interesting point, when I go back to using AI in terms of driving efficiency in our organization, not only does it, you know, when we're using AI and use cases, we're seeing often times 60% cost reduction, 50% faster time to market. That calculus example, we were able to bring a calculus program, which everyone knows the McGraw brand. We didn't actually have a calculus offering. We did pre-calculus and different math courses, didn't have calculus.

We were able to bring that to market 50% faster than we would have without using AI tools. And that was something we launched this year.

Marlane Pereiro: Yeah, federal funding has obviously been a big topic, you know. How have recent federal education policy changes impacted your business thus far?

Bob Sallmann: Good news is, you know, we haven't seen any impact. So first, let me say, you know, whether or not the Department of Education – what that may look like doesn't really impact our business. So a couple of different things is while there is funding at different levels, the Department of Education, while that funding will just move to a different organization, when I think about where funding comes in and let's just talk through, you know, starting in K-12 and that's where the questions often come in.

We have not seen any impact and a real, relatively small portion and I mean single digit of a district's budgets in K-12 is actually for course materials. So if you think about their overall budget, very small portion, and that means that the federal budget is, you know, two or 3% while you have state and local driving the remainder of it, majority of their budgets are going to staff. Now, what's really important is also, and I've talked about it several times and what we really focus on is driving efficiency for the educator. Our ability to do that allows those dollars that the district is funding to be more efficient.

Right. So as they know, it's a small portion of their budget, but we're driving efficiency for the educators. So when they're looking at budget constraints, budget dollars, that's not an area that they typically look at because they acknowledge the fact that our tools are allowing those classroom teachers to be more efficient. So as we reflected back on sort of, any sort of budget challenges, we have not seen any impact on the federal government small portion and whether, you know, funding comes from the DOE or elsewhere in

higher ed, you know, it still will remain intact.

Marlane Pereiro: And then, you know, given that most K through 12 funding is state and local.

Bob Sallmann: Yeah.

Marlane Pereiro: Have you seen any indirect effects from federal initiatives, some hesitancy, uncertainty that could be affecting decisions?

Bob Sallmann: Now, certainly when we talk about core and core would be, you know, ELA, math, science, social studies, and that's our biggest portion of our business today. 85% of our revenue is supporting the core in K-12.

There's been absolutely no funding delays, challenges, or anything around that. I think students need to have those materials. They need to support their courseware. So we have not seen any impact. On that remaining percentage, supplemental and intervention space, there has been some hesitation, let's say a little bit more thoughtfulness. Now, would I say it's more widespread? No, I'd say it's pretty consistent with years past where they're very deliberate with their spend and how they are utilizing their budgets.

But we haven't seen anything widespread that would tell us that funding is being withheld.

Marlane Pereiro: In the shutdown, any impact on the business thus far? Anything that you could anticipate, or we should look out?

Bob Sallmann: No. And similarly when we talked about, you know, any shutdown, any impacts to our business, none. The other one I do like to call out is obviously we don't have impact from tariffs.

So as you've walked around and heard different impacts from other businesses, we have no tariff impact either. So we've been fortunate in that regard.

Marlane Pereiro: And then obviously State Adoptions a big, another big topic, California math, Florida ELA, obviously major opportunities in '27, '28 cal., in those years.

Bob Sallmann: Yes.

Marlane Pereiro: You know, how are you positioning now to capture those wins?

Bob Sallmann: Sure. And just to sort of level set, in our K-12 business, we have, you know, market opportunity that is variable, right? So it's predictably variable. So the way we think about it and there's three large states and that's really driven by population of of those states. California, Florida, Texas. They operate a little bit different than other states. And what they do is they'll have a statewide procurement cycle.

And so what you're describing is how we look out into the next several years. And so this year was a predictably smaller market opportunity than last year. We had the benefit of Florida, Texas-Florida, and Texas science programs last year and this year the market is relatively smaller. And as we look out into our fiscal '27, that's next year, and then into '28, the market opportunity that you described first being math followed by ELA is accelerating and growing. That's really important as well. Not only is it the market opportunity is bigger, which gives us the right to go out and compete and win. We've already been put on the California list, which means like, you have to make the short list

to go out and compete district by district.

So we've been put on the list and we, as our strategy, we play everywhere. We fully intend to be on all of those. So we made the list, we're out. We also highlighted on our last earnings call that we've been awarded two significant districts in California.

That's important because momentum, like anything, is real. And so as the superintendents are going around the state at conferences just like this, talking about their business, what they've selected, the fact that these two influential districts have selected McGraw Hill for the new math curriculum is very helpful. And so it plays to our strengths. If we look at, you know, our relative revenue composition in our K-12 business is more heavily weighted. First being ELA is our biggest followed by math. And those are then the next cycles that we're walking into. So bringing new products into market always plays out very favorably for us. And then the next cycle being math and ELA driven is also very beneficial for us.

Danielle Kloeblen: I'll just add on the math side, we have a really comprehensive offering in market, right, with the core program and ALEKS Adventure, our new supplemental offering for K-5 and then McGraw Hill Plus, which goes over the top and integrates with third party assessment.

Bob Sallmann: And maybe just to double click on that just a second. So in our supplemental intervention, again, reminder of 15% of our business, the key on that is today we have about, you know, 25 to 30% share in the core. That's, you know, ELA, math, science, social studies. Supplemental intervention, we have 5% share. So why relatively smaller? We believe we have the right to win there and compete and we have opportunity to grow that share to be more like our core. But we also didn't have a full portfolio of offerings. So as we've now launched, you know, the younger grade and math supplemental intervention that happens to coincide with this new cycle that we're mentioning.

So again, not only work for, you know, our ability to win and compete in core, but, you know, having a more comprehensive solution and supplemental intervention will definitely play out in our favor.

Marlane Pereiro: Is there ever been a scenario where adoption cycles are unexpectedly delayed? Is that ever happened?

Bob Sallmann: You know, we just experienced an ELA cycle pull forward. And so what you'll generally see as moving things forward and again, the state boards of education will give 3-to-5-year visibility out. And that's why I said it's a variable but very predictable business that we operate in our K-12 business.

So in that cycle, California ELA was going to be a '29 move forward. So as they move it forward a year, you'll start to see the benefits, so more likely to pull it in because they see the merits and benefits of having the new program. And again, they have the state standards that they want to be addressed. And so the state is motivated, but they have to work with McGraw Hill and others, you know, our competitors to ensure that we can meet those deadlines.

So we're having discussions with the boards of education and, yep, we can deliver in time. So they actually moved it forward. I'd say that that's more common than actually a delay because they're motivated to actually get product in in the market. So from launching say that five years out you might see a year pull forward, but typically they build those, those milestones, and targets to ensure that the providers can all be ready for those delivery dates.

Marlane Pereiro: Great. And then, you know, following the IPO this year, obviously, you know, large portion of debt reduction as well. How are you prioritizing capital allocation between reinvestment,

Bob Sallmann: Yeah,

Marlane Pereiro: delevering, M&A. And then on the topic of M&A, where are your focus areas?

Bob Sallmann: The first place we always invest, we fully fund all of our organic growth opportunities. So that's always in our budget. They always have the best ROI and they're fully funded. So then what we're left with is, and the fortunate part of our business, we generate lots of cash. And so in October we paid down an incremental 150 million in addition to the IPO proceeds to pay down debt.

So that is really the balancing the right balance between M&A and debt repayment. Today as we look at that funnel, and this will help sort of figure out where that balance sits as there's nothing transformational as we think about what we're going to do. M&A is really going to accelerate our product roadmap, or it could be an adjacency or small tuck in bolt-on. So if you look at sort of what zip code those are and we're going to use cash on the balance sheet and get those things done to accelerate our growth or accelerate our technology roadmap. We just closed a little while back on EssayPop and again, that's a prime example of the make versus buy. We canvassed the marketplace. We knew there was great technology out there that we incorporated now in our Next Generation ELA program that we talked about just a moment ago. And so we were really torn saying, do we make it or do we just buy it? And so we went out and bought it. So those are the kind of things that I think you'll see us continue to do on the M&A side, nothing transformational, nothing that would ever, you know, lever up the business and then, you know, ultimately balancing that pay down over time, we've stayed at our target leverage of 2 to 2 and a half times. We remain committed as evidenced by our October repayment.

Marlane Pereiro: Great. And then, you know, right now, if I look at Moody's and S&P you have positive outlooks on your debt just from a longer term perspective, you know, is, you know, kind of an investment grade rating, something you aspire to or just kind of, you know

Danielle Kloeblen: Yeah. Yeah, no. I mean, we have great dialogue with the rating agencies, very constructive. And as you noted, both on a positive outlook. And we recently got upgraded by S&P, which is great to see. You know, as Bob mentioned, we're committed to our leverage target 2 to 2 and a half times and, you know, when we think about M&A, you know, nothing that would require us to lever up the business in any way.

Marlane Pereiro: And then, you know, from an industry consolidation perspective, you know, do you think it will favor, you know, diversified players, mostly tuck ins assessment supplemental providers? Obviously, we touched on, you know, AI first entrants but from an industry perspective, how do you see that playing out?

Bob Sallmann: From a broader industry I really think scale matters. Data is what's going to drive that personalized learning and that goes through life, right? Personalized learning is the Holy Grail. Everybody's been, you know, moving towards that direction. But without really that rich data, and again, ours our data runs K through life. So part of that we talked about McGraw Hill Plus, that's longitudinal student learning record. So it's akin to a medical record, but it would be your learning record.

And so if you have children, you can think about your student going from third to fourth grade, then fourth or fifth. Those teachers are inheriting those students they now understand how they learn what's their best outcomes for them, how to teach to them. So

that data becomes really, really critical.

And so as I mentioned it before, I think scale in this industry really matters. And we, we get lots of calls from ed tech startups and hey, you know, we just don't have the scale. We don't have the scale, we don't have the channel to to enter the market, we don't have the data to ultimately drive these really cool tools we've created. So I think scale is going to matter. You're going to see, you know, there's big three players in both K-12 and in higher ed. I suspect you'll see both growing in terms of adding more capabilities and supplemental intervention as we are a core player. Core is very difficult to get into. There's a high moat, barrier of entry, very expensive. So I don't see there being tons of new core providers and I can see there being consolidation and supplemental intervention. Lower barrier of entry, the lot of really cool technology they're creating, but without the underlying data, I think they're missing a big element. So I imagine that there would be some consolidation in that space.

Marlane Pereiro: Yeah, I mean, for the right opportunity, you know, given the dynamic nature of the space right now, you know, would McGraw Hill entertain, you know, a transaction that might temporarily bring you out of your leverage profile?

Bob Sallmann: You know, I think we have all the attributes that we look for today. There isn't anything that we've looked at our portfolio and said, we're this. We made a large acquisition of A3K in 2020. And it was really saying we, we were missing a part of our portfolio and that was a supplemental intervention product and ELA. But if we look at our portfolio today, there isn't anything that we're missing. And so I don't think it makes sense for us right now. You know, we have all the tools and all the equipment we need. We may make small tuck ins just because it accelerates our roadmap. But I don't I don't really see anything of scale being needed to that tomorrow.

Danielle Kloeblen: And the other thing that we have that no one else has is the red cube, the logo, the brand. That brand and the power, the trust that goes along with that brand is something that really differentiates us in the market, especially getting us in the door, having conversations with educator, being that partner that Bob mentioned, so that along with our moat, right, our IP, our data and that domain expertise is really a differentiating factor for McGraw Hill.

Marlane Pereiro: And, you know, you recently reported a strong quarter. We've touched on higher education, market share gains. You know, can you remind us of some of the other key drivers in the quarter? And ultimately what led you to raising your full year guide for the year?

Bob Sallmann: And one of the nice attributes of our business is that predictability of it. So in our K-12 business, we have the back to school selling season. We get multiyear revenue related to those contracts, the way school districts work and those who don't know our space, the most incredible thing, we get 5 to 8 years' cash upfront. That allows us then to have clear visibility of the revenue recognition over time. So that predictability and visibility has been very helpful. So we built our RPO or our deferred revenue and then the other really strong indicator is higher ed. And so what you have a tendency to see the fall semester and spring semester, there's a direct correlation. So for us really big, really important second quarter and because of the success of the quarter, we executed really well. That gives us that confidence and conviction to go out and raise our guidance for the full year.

Marlane Pereiro: Great. And, you know, as we think about, you know, next year, what are you most excited about for McGraw Hill?

Bob Sallmann: Well, the things that really excite me is that we're continuing to take share across all of our businesses, right? So if you look at all four of our segments, we are winning in all of them. We're continuing to win. And that allows us to innovate and continue to build and innovate at a greater pace than our competition. So we are well positioned not just for next year but for the next ten years and beyond. So really excited about our ability to keep winning and taking share.

Marlane Pereiro: Great. We have very few moments left, but if anyone has a question, we can squeeze one in super quick.

Audience: Obviously, there was a big acceleration during during the pandemic with digital in the classroom is where do you see like I guess what inning are we in in terms of digital adoption, particularly in core? And over the next couple of adoption cycles where, where is the biggest opportunity like in which a grade ranges?

Bob Sallmann: Yeah. So, so, K through five still remains largely print, and parents and educators want the younger learners to stay in a print format. So I don't know that you'll see a ton of a change. Now for us, supplemental intervention is digital at all grade levels and we're seeing that. And so as we, as McGraw Hill, moves to have more supplemental intervention, as Danielle mentioned, we have a new math offering, our relative digital mix will continue to increase. So for us as an organization, I would say that we're still in the middle innings in terms of our ability to grow in K-12. Now, in higher ed, we're 92+ percentage still today. Yes, I do think it's going to continue to grow, 98%. And I can tell you, if you go on campus, you can see the professors that are still teaching from a textbook. They're not going to always be there and there probably won't be teaching that much longer. The younger professors have all moved digitally, so I think there's still some room to grow.

Certainly internationally, they're lagging 3 to 4 years behind the North American, U.S. market. So that's why I put us in the middle innings. So there's still more to go. And obviously the great part about digital is it's a higher, higher margin profile business as well. So again, we like the attractive and predictable nature of that recurring model and we'll continue to grow for the next foreseeable future.

Marlane Pereiro: Great. Well, Bob, Danielle, thank you so much. It's a pleasure.