

McGraw Hill Education

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10:15 AM MST

Josh Chan: All right. I think we're live. So good morning, everybody. I'm Josh Chan, a business services analyst here at UBS. Very pleased today to have McGraw Hill join us. They are a leading global provider of educational content and software for higher ed and K-12 markets. With us from the company today are Bob Sallmann, CFO, and Danielle Kloeblen with IR. We're going to do a fireside chat, so if anybody has any questions, feel free to raise your hand. You can also find a way to send your questions up here to the iPad, and I'll pass them along. But Bob, Danielle, great to have both of you join us.

Bob Sallmann: Thanks for having us.

Danielle Kloeblen: Thank you.

Josh Chan: Thanks for being here. So it's been a busy year, given the IPO. So for investors who may not be as familiar with the story, could you start off by giving a brief background about McGraw Hill, and then we can go from there.

Bob Sallmann: Sure. McGraw Hill, you probably know the Red Cube, our brand. It's been around 137 years, supporting learners and educators across the globe. What has really evolved over the last 10 years is how the business has become very digital. Today over two-thirds of our revenue is being digitally delivered. And the key for us of what has happened in that evolution is now we're moving towards the Holy Grail of education, which is and will always be personalized learning. And it wasn't until we could start to digitally deliver to allow this to happen. Because you can imagine the scenario of one teacher in a classroom trying to serve 25 students--not happening.

We've been utilizing machine learning for 10 years, which is predictive analytics helping us move towards true personalized learning. Now we're seeing it evolve even further with the use of AI. So for us, AI is a clear tailwind, and we'll talk about how we're differentiated. But you're seeing that we're able to use it to improve learner outcomes, personalized learning, remove the administrative burden for educators and ultimately reduce our time and costs to develop content.

Josh Chan: Well, a very different company from a--

Bob Sallmann: Completely different from textbooks. If you were to walk into a higher education institution today, you will not see a textbook. So the businesses have evolved from when I certainly was in school.

Danielle Kloeblen: And the financial model has also strengthened. Very predictable, very high quality, strong margin profile, and we've been able to continue to invest in innovation while still expanding margins.

Bob Sallmann: Yes, and I think it's important to highlight that. So as the business has evolved more and more digitally, we have about 1,500- to 2,000-basis-point margin expansion, but again, allowing us to further innovate and continue to invest. And so scale matters in our business, and we'll talk about that in more depth. But we serve K through life. And again, that's differentiated from others in the space, and that allows us to have consistent platforms leveraging our cost structure, leveraging our innovation across a broader portfolio.

Josh Chan: Great. Thanks for that overview. So I guess as you look across your market, particularly within the US, what do you think is the addressable opportunity, and how do you think about the pace of market growth?

Bob Sallmann: Let me talk through a couple of those segments individually. So in higher education when we think about the market, we are expanding our TAM. We have launched new calculus programs, we are expanding into different workforce readiness. We serve--and again, it's important to understand where we serve. So 30% to 35% of our revenue is coming from 2-year community colleges. So where we have lots of courses that transcend both 2-year and 4-year schools, we're also seeing a lot of that workforce readiness and workforce improvement. So we serve that. And that market is absolutely growing.

Overall enrollments will be relatively moderating. We talked about in our second quarter we grew 14%. In that business we had published data that said 2.4% student enrollment. We experienced something a little bit higher, maybe 3.5% to 4%, based on the mix serving those 2-year schools at a higher percentage of our overall revenues.

So we'll continue to expand through both innovating new products, expanding our TAM. We launched a product, Sharpen, which is also a new product that we've introduced to expand overall TAM and serving students and providing more study aids.

Ultimately what you'll see is we are growing through share, and we're doing that through lots of innovation, having the best go-to-market in the industry. And because of that financial profile we talked about, we're able to leverage our investments across our entire portfolio, bringing new products faster. Again, we're happy to go into some of the technology and advancements.

I will highlight one of the things that we think about that overall market. It's interesting to think about our ability to take share. Today we have 30% share in higher education. We were at 21% just a few years back. So we're doing that by innovating at a greater pace.

When I talk about the K-12 business, about 50 million learners in the US. That's a relatively stable number. And we don't get too hung up on enrollment the way that we actually monetize our revenue streams, and that's because we sell to a district. If you have 920 students, we will sell license for 1,000 students. So 1 or 2 percentage points up or down doesn't really impact our revenue stream.

But what does is our ability to expand the TAM, and that's by having more offerings. So within that 50 million students, there is core materials, and today that's about 85% of our revenue. And that is English, math, science, social studies, core product offering. 15% of our revenue stream is supplemental intervention. And today we only have 5% market share. If you look at our share in core, it's 25% to 30%. We've expanded our portfolio in core. We've recognized the value to the institutions, to the educators, to have a connected classroom. What we mean by that is having both supplemental and intervention and core, and there's benefits to the learning outcome. So as we've now added a more comprehensive portfolio, it positions us well when we go to sell into those districts. So again, that's the TAM expansion.

We realize price, and we're getting price because we continue to add value to our offerings. And again, we'll talk about some of those innovative solutions we've added. All of that is allowing us to continue to grow and take share.

Josh Chan: Great, thank you. So one of your advantages has always been the ability to develop trusted content.

Bob Sallmann: Correct.

Josh Chan: And so what content development capabilities that you have that maybe your competitors may not? And then basically how does McGraw Hill differentiate itself on the content side?

Bob Sallmann: So we talked about the brand and the reputation. We've been doing this for a very, very long time. And so when we think about the content, it is two things that we're getting. It's delivering the best content, and that is the pedagogy, the science of learning and having hundreds of employees dedicated to the science of learning. And so it's the content, compounding that with how do students learn and how do we improve that outcome?

But it's really the data that now is coming off of our platforms that moves this to a personalized learning experience. So it's the combination, really, of having the best content, working with Nobel laureates developing our content and having our reputation, but combining it with the platforms to give us all that data. And that's where we're getting 19 billion learning interactions annually on 25 million paid digital users. All of that is what really makes the power of our content is combining with all the data.

Josh Chan: Maybe it's a good segue into the AI, usage of AI in the business. So can you talk about how you're using AI, both to develop content but also the other uses that you have?

Bob Sallmann: Sure. I'll even give you a couple of use cases as well, but primarily it's in three ways we're using AI, and that is that personalized learning journey, now enabled by AI. It is reducing the administrative burden upon educators, and that is absolutely a challenge, utilizing teachers more effectively in the classroom, spending more one-on-one time with students. So that is something that we're focused on as well as content and platform cost reduction and time to market.

So let me give you a couple of examples of each of those. So just a couple of weeks ago, we launched Teacher Assistant. And that really is a tool allowing them to lesson plan directly tied to what the students need in their classroom, so getting insights as to where their students are falling behind, tailoring their lesson planning for educators. And why that was so important is we're getting feedback from the districts saying, "Yes, we had curriculum coaches, but when our budgets are under pressure, we're removing curriculum coaches." Well, now we've created tools to help them improve those lesson planning specifically for the needs of those students.

Similarly, we launched something called Writing Assistant. And so this one's something that is impactful to me. My wife was a classroom ELA teacher, 12 years in the high school setting. And the scenario would be my wife, 25 students, 50 minutes to write that essay. She'd walk around and have 2 minutes per student. What the tool is doing is prompting the students, helping them get started on their essay writing. So it's like, "Who is the main character in the paragraphs that you write?" Once they understand that, it would say, "Okay, write about Johnny. Okay, what was the conflict that Simon or Johnny faced?" So it's helping them get moving. Now, the key to that is preserving the productive

struggle in education, and that is so critical. We understand that deeply, and so that's how we infuse that sort of process.

So when I showed my wife this tool, she was blown away. She's like, "Wow, if I had that when I was in the classroom, I probably would still be there." So it allows them to have that more personalized learning experience.

Similarly, in higher education we launched something called our AI Reader, which is effectively you read a passage, really complicated chemistry passage. "I don't get it." Highlight it, "Explain it to me in a different way." And we've all used those types of tools. And so, "Okay, great. I still don't get it. Explain it to me in another way. Okay, I think I got it. Quiz me on it." So that's embedded into our platforms, and what we're seeing is that the time on platform is increasing, and that is one of the most single important metrics to see the learner outcome. So we're measuring that. We're seeing that it's been driving efficacy and improvement in students.

Lastly, is around that content creation. And again, we spend meaningful dollars every year on content. We've launched something called Scribe, which is a tool that helps us create content in a very streamlined fashion. And so the use cases would be things like in our medical business. So if you're a medical student in the US, you're going to be using AccessMedicine if you want to become a doctor. And we used to pay lots of money to doctors to create question banks. And so those question banks now can be created through AI using our content in a walled garden, creating all those questions, and then we have a human in the loop, a doctor, then, to review it. So you can see the cost and time reduction.

Similar with summary passages that we have at the end of every chapter. You can imagine writing content for fifth grade. You can imagine that now we can say, "Make that for seventh grade. Make that third grade." So all of that content and then using the human in the loop to drive meaningful efficiencies.

So those are the areas that we're seeing AI. And again, we have a big benefit. Let me explain why we have a benefit relative to other competitors, and it's really four pillars I think about.

One is the brand you've heard me talk about. Red Cube is well known everywhere, so it gives us the right to go talk about our products.

Second is the IP. We talked about that. The content, 137 years, well trusted, well known, combined with the platform. The platform is now extracting this third and most meaningful data point for me. It's all the data coming off the platform. So now combined with the IP, we have all of the data to move towards that improved personalized learning insight.

And the final differentiation we have around using AI is really around the go-to-market. And this still remains a very relationship-based selling process. There's 15,000 districts in America, 4,000 higher education institutions. We sell to all of them. We have our staff, most tenured, most knowledgeable. But what we really get from that is they deeply understand the challenges facing educators, so we get all that insight. We help them solve their problems, and we're creating tools that really are meaningful for them.

So that really differentiates us, and ultimately scale matters. And so to have all that access to data, having access to all of those educators and institutions, you really need scale.

Josh Chan: Sure. So are you making the case that even if smaller competitors can also use AI on their own, these are some of the protective factors that allow you to use AI in a bigger way?

Bob Sallmann: Correct. And like I said, scale really matters. It's that distribution channel, it's the trusted brands. I had heard from our teams that they were at ed tech conferences recently, and they were saying, "Well, if we just had that Red Cube, it would allow us to go in and sell." Okay, well, if you had the Red Cube plus you have 1,500 sales staff, and then you have access of that longitudinal data, so yes, the Red Cube really matters, but it's all of those four items that really gives us that protective mode.

Danielle Kloeblen: And Josh, I think the one thing that's often overlooked is we've been using machine learning for over a decade in our solutions. So we have a strong history here. Very deliberate use, very responsible use, which is very important when you're dealing with higher education and K-12 schools.

Josh Chan: Sure, sure, absolutely, okay. And then one talking point has been that if AI is able to take out so much cost with content development, does that ultimately reduce the price, or does that benefit ultimately get passed on to consumers? How do you think about that?

Bob Sallmann: Yes, we've got a very disciplined model around pricing, and it's a value-based pricing model. And so it's interesting. When we talk about all of these AI enhancements that we have, are they revenue generating or are they revenue enhancing? And so what I'll tell you is high level, we go out to a district and say, "Here's the value we're delivering. Here's how we're making teachers more efficient."

If we go out with price, it stinks. When we think about pricing in both K-12 and higher ed, it's not--in a decision matrix, it's not in the top five, ever. It's always lower, and it's saying, "Look, we want to understand the efficacy, driving efficiency." All of those things we're going to continue to further enhance. So when we go out and sell, we've added features, we've added capabilities that allow us to continue to drive price. So while we can take cost out, we don't see there being pressure because we're going to be adding so much more value to the institutions, the educator, providing them more time to actually teach.

Josh Chan: Any questions from the audience? Okay. Maybe moving on to your sales force, so that's another advantage that you have. Do you have a sense for how big your sales force is compared to the competition, and how important is it to have a sales force that enables you to gain share?

Bob Sallmann: Well, let me explain one differentiation, and this one is really, again, a personal story. I was at my alma mater last year, and we're going around with a rep in selling our product. And it was really interesting, as we have--our go-to-market is different in higher education. What we have is customer success. We invested in 80 customer success professionals. And what that individual does is help the professors set up their coursework. And again, this is a software tool where they're adding all of their videos, they're adding a lot of materials, spending a lot of time to set this up. Well, we've got a dedicated team that makes this a bit unique to us.

So I'm walking around, and we're knocking on doors of professors, telling them about our great products and how we're differentiated with the new AI tools we're bringing. Professors would open the door and come out and hug the customer success. "You've made my life so much easier." And I was blown away. So it was a meaningful investment we made, and I knew at that moment. I saw first-hand it pays dividends. That has been something that we were--when we invested in it, we knew it would resonate, but I had no idea how powerful it would be.

So the way we go into market is slightly different than our competition, so sheer numbers. If you said, "There's 500 higher education reps, 80 dedicated customer success," by numbers, I don't have an exact how does that compare to Pearson? But I can tell you our go-to-market is differentiated, and we made a meaningful investment. Our financial profile, being different than some of our competitors, allows for us to make these investments while continuing to expand margin. So we made that investment, and that has been showing in the share gains that we demonstrated.

So in our second quarter, which we just reported our results, we took 160-basis-point share gains. That is partially driven--and that's on an LTM basis--that's partially driven by the fact that we made this investment over the last couple of years in customer success. Very differentiated. It's allowing us to win.

So again, it may be partially having numbers that we can actually go out and see people in the field. But the tenure of our sales reps are greater than those in the industry, and we've looked at that and have proven that tenure really matters, understanding the challenges of educators today.

Danielle Kloeblen: And Josh, these customer success reps are focused on data. You said additional solutions, which obviously helps. They want to make sure that they're being optimized and used as effectively as possible.

Bob Sallmann: Yes, so it's then using those insights to then say, "Hey, here is your dashboards. Are you using this insight to educate those students to ensure that they're actually comprehending and truly learning the information?"

Josh Chan: Sure, okay, that makes sense. Maybe pivoting to your financial algorithm, so you've laid out some financial targets, including 5%-plus growth over the medium to longer term. So could you talk about what it takes for you to grow 5% and plus over time?

Bob Sallmann: Yes. Let me walk through it by our segments. So first I'll address in our higher education space. So again you may hear about enrollment headwinds that we would face over time. And what I will tell you is we experienced 3.5% to 4%. That will moderate over time, but we don't lose any sleep, as I mentioned, about enrollment. So what you'll see is those 2-year community colleges, workforce training, workforce readiness, that will continue to offset the 18-year-old demographic first-year student that would be declining. So as we think about enrollment, it's relatively neutral to us over time.

Our ability to continue to get share is going to be the biggest single driver of that. We've demonstrated that we've done this for the last decade. We're innovating at a greater pace. We're making greater investments, not just in the technology but in our go-to-market, allowing us to take share. And then the price that we go out with stinks, and so that could be that inflationary level price. And then lastly, I would say what's driving share gain? We're also expanding SAM within the TAM we're adding. So again, those are all the factors.

If I come on to K-12, enrollment is not a factor as we think about the 50 million students. So what is it? It's really our ability to continue to take share as well, and we do that by adding through TAM. And I want to highlight when we think about 15% of our revenue in K-12 is this supplemental intervention space, which is a larger overall market than the core market, our ability to move today our core, and we're well known as a core provider, 25% to 30% market share. We're a leader today. But being able to take that supplemental intervention space where we have 5% share and growing that more in line, more consistent with our overall core, and there is efficacy, there's lots of reasons, and we talk

to educators. They want to have that connected classroom. So a third-grade student, they have a character in their math curriculum that transfers then into supplemental intervention and allows them to move seamlessly between core offering in the classroom and then you're addressing state standards in a similar fashion. That is one area that we know we will continue to grow.

And so as we do that, and again, smart digital, so as we talk about overall margin, having a more digital profile in our K-12 business, that is margin accretive.

Internationally, let me just come back to that. Internationally, we haven't talked a whole lot about it. 10% of our business. We are operating in some very attractive end markets in LatAm, the Middle East. Those are areas of strength for us and they'll continue to grow, so we like those end markets, which have a different sort of demographic data than the US.

And then in our Global Professional business, maybe 8% of our overall revenue, today we serve medical education, a growing end market. What you'll see if you actually deconstruct and look at our financials, you'll see that Global Professional has been relatively flat over the last couple of years. That's because we've discontinued non-strategic print titles that were consumer facing. As that tail unwinds, what you'll be left with in our Global Professional is that critically enabling mid- to high-single-digit growing business serving medical and scientific students, primarily globally. So it's not just a US business.

Josh Chan:

Great, great. And then on the margin front, you put out the 37% EBITDA target, so what are the levers there?

Bob Sallmann:

Sure. Let me start on the gross margin side. Again, moving more and more digitally, and all four segments will continue to move more digitally, and we're still in the earlier innings. Higher education is 92% digital today and growing, so we expect that to exceed 95% digital. And again, as that digital mix grows, you'll see a higher flow through higher margin expansion.

You'll see the same thing happening and playing out in K-12. Where we move into supplemental intervention, that takes all digital offering regardless of grade level. And it's important to recognize K-5 is largely print, 6-12 is largely digital. But the supplemental intervention, regardless of grade level, is digital. So you'll see margin expansion.

International markets are 3 to 5 years behind the US in terms of their digital penetration. That will help us. And as I mentioned, we'll roll off the print components in our Global Professional. So all of our segments will become more and more digital over time. Gross margin expansion.

We will scale the business. Today we serve those critical markets in the US. We have full representation for our sales and go-to-market, don't need further expansion to sell into the supplemental intervention space, for example. And our back office and all of our support functions are already there. So we will scale the business.

The last piece, and the 37%. I put the asterisks there and I call this out every time I have an opportunity to tell people, saying the cherry on top is that Scribe. We have not factored that in, in our near-term guidance of 37% growing from 35%. And that is our ability to take cost out of the content creation. So as we develop the content, we reduce meaningful cost, yet we know that we can continue to value sell. That will be margin accretive over time as well. And that goes beyond the 37%.

- Josh Chan: Okay, great. I want to give some time to the higher ed business because you've had some strong success there recently. Could you just talk about what's contributing to the share gains and how durable those dynamics, those drivers are?
- Bob Sallmann: Yes, so we've been demonstrating that share gain for the last decade. We've been consistently taking share. And the drivers are the level of investments that we are making relative to our competition, so we're investing at a greater level. And then that becomes that virtuous cycle where we continuously have more cash flow to continue to further reinvest. And so we're making greater investments, not just in technology, and that's all the technology enablement around AI. It also includes that go-to-market. So as we've invested in go-to-market, we know that our platforms consistently rank number one in any of the surveys. So as you can stack all of it and you say, "Okay, content. How do we rank?" Well, if the content and platform, and that's that delivery with the insights going back to professors, consistently the highest ranked in the industry. That will allow us to continue to grow.
- But I do want to highlight one more feature that we've launched. It's called Evergreen. And this is unique to us. Evergreen's really important because that's going to be the next fuel for this share gain. And what effectively Evergreen is would be an iPhone update for your courseware. The way the cycle works today is you have editions. 3 to 4 years, a new edition comes out, the professor has then an inflection point. "Do I stay with McGraw Hill? Do I go to Pearson? Do I move to Cengage or vice versa?" And that's the point which you actually have some turnover. In that cycle, you generally have a pretty high level of retention.
- What we've done now is remove the edition cycle. We're first to the market to do this, and I suspect others will follow, but we've got a couple-year head start. It took us a few years to develop this. But essentially what you're doing is you remove the edition cycle. Now the professor saves 40 to 80 hours of uploading their syllabus and their course materials and everything into the courseware. You've removed that pain point. And then the other thing we've done is ensure that students have the most relevant data, and this becomes more and more important as you think about workforce readiness, having all the most relevant materials. You can imagine studying economics and not talking about current tariffs. It would be crazy.
- Similarly on any sort of workforce readiness, having that material available for students is helpful, but for us and why it's going to drive share gains is today our workforce spends half their time defending the backyard. What I mean by that is a new edition is coming out. We spend time discussing it with the professor, what the benefits of the new edition are, why they should stay with us and not giving the opportunity to look at something else, and we're now giving our sales force a time machine. We're basically saying, "Go spend your time getting those takeaways. You know the edition cycles from our competitors. Go out and win share."
- Today two-thirds of our revenue is delivered through the Evergreen model and growing, but it really is allowing our sales force to really focus on takeaways. And that's going to be the next fueling level of accelerated share gains.
- Danielle Kloebler: And Josh, it's also more deeply penetrating the institutions we already serve. We think that there's lots of runway left ahead of us on that.
- Josh Chan: Yes, okay, that's great. And maybe touching on the K-12 business, you also recently have had good capture rate success there. Could you just talk about what's driving the improved share?

Bob Sallmann: Yes. Well, last year we launched a new science program, and that program went into Florida and Texas. And we discussed publicly saying that we had 2 to 3 times our normal share captures--phenomenal. So we performed exceptionally well. The question is how come? We created a new program that had the right mix of digital library assets, meaning that that educator in the classroom wants to personalize the learning, wants to bring digital, video attributes, different digital content into the classroom. That was really well received.

All of the planning tools that we embedded inside that program was hugely successful. And again, this still remains a relationship business, so we have those deep relationships. We understand the needs of the educators. That allowed us to be hugely successful. So that example and what we've learned, we continue to deploy that into our next cycle will be math, followed by ELA. And interestingly, if you look at McGraw Hill and our history, the strength of our core is first ELA, and that is the next cycle, and math. Those are our two strengths of our content areas, and that's the next cycle that we're seeing as we look out in the next several years.

And the thing that is really attractive about that K-12 business is the predictability. So you get insights from state boards of education 4 or 5 years in advance when they're planning to have these bigger adoption cycles. So we have clarity around what products we need to bring to market, when they will be needed, and we just are delivering them with the right balance of materials to allow teachers to be more efficient, digital capabilities, and then now partnering that with all of our supplemental and intervention tools. It's just fueling it.

The last part I will highlight is that we now are bringing McGraw Hill Plus, which is now akin to a medical record, but a longitudinal learning student profile. And so now what you've done is now as we think about this will play out is we have fourth grade students going into fifth grade, we have individualized learnings of how that student learns, how they best perform. We can do it across multiple subject areas as we've launched this with ELA. It's patent pending, but allows teachers to further personalize that learning experience. So all of those features are really differentiating us and allowing us to continue to take share at a greater pace.

Josh Chan: Great. Maybe one with this. So you're a couple of months after IPO. If McGraw Hill is successful over the next 3 or 4 years, what will be the main reasons driving this?

Bob Sallmann: We will be successful, and it's going to be that continued share gain. And we know that we are innovating at a greater pace than our competition. We can utilize AI in our--the moat in which we use AI is deepening and widening every day. Those are the features that are going to allow us to be successful. Share gains across all of our segments. And then ultimately you'll see that that's improving outcomes for learners, and educators being more efficient and reducing the burnout on administrators. So all of those are the factors that are going to allow us to be successful. We're deeply committed to the mission. When you talk to over 4,000 of our employees, everyone is former educators passionate about our mission, and so ultimately you'll see the financial profile expanding, taking share and growing, but ultimately improving the learner outcome and education burnout, reducing that as well.

Josh Chan: Okay. I think we're out of time. Bob, Danielle, thanks for joining us.

Bob Sallmann: Thanks, Josh. Yes, I'm glad to be here. Thank you.