

**GSX Techedu Inc.**  
**Second Quarter 2020 Financial Results Conference Call**  
**Wednesday, Sept 2, 2020 08:00 AM ET**

**Operator**

Ladies and gentlemen, thank you for standing by. And welcome to the GSX Techedu Inc. First Quarter 2020 Earnings Conference Call. (Operator Instructions). After today's presentation, there will be an opportunity to ask questions. (Operator Instructions). Please note this event is being recorded on Wednesday, May 6th of 2020.

I would now like to hand the conference over to your first speaker today, Ms. Sandy Qin, IR Senior Manager of GSX. Thank you. Please go ahead.

**Sandy Qin**

Thank you, operator. Hello, everyone, and thank you for joining us today. GSX's earnings release was distributed earlier today, and is available on the Company's IR website.

On the call with me today are Mr. Larry Chen, GSX's Founder, Chairman and Chief Executive Officer, and Ms. Shannon Shen, Chief Financial Officer. Larry will give a general overview, and then Shannon will discuss the financials. Following the prepared remarks, Larry and Shannon will be available to answer your questions.

Before we begin, I'd like to remind you that this conference call contains forward-looking statements as defined in the U.S. Private Securities Litigation Reform Act of 1995. These forward-looking statements are based upon management's current expectations and current market and operating conditions, and relate to events that involve known or unknown risks, uncertainties and other factors, all of which are difficult to predict, and many of which are beyond the Company's control, and may cause the Company's actual results, performance or achievements to differ materially.

Further information regarding these and other risks, uncertainties or factors is included in the Company's filings with the SEC. The Company does not undertake any obligation to update any forward-looking statement except as required under applicable law.

As a reminder, this conference is being recorded. In addition, a live and archived webcast of this conference call will be available on GSX Investors Relations website at [gsx.investorroom.com](http://gsx.investorroom.com). You are also welcomed to subscribe to our quarterly investor newsletters through the same website.

It is now my pleasure to introduce Larry. Larry, please go ahead.

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## Larry Chen

Thank you, Sandy. Good evening, and good morning to you all. Thank you for joining us today.

First, we are pleased to see that the country has continued to flatten the curve of new COVID-19 cases over the last few months. Against this backdrop, we made a concerted effort to deliver another robust quarter. Net revenues hit a record high, supported by our focused strategy and notable organizational capabilities. The numbers say it all. Our net revenues and gross billings once again both maintained over 4 times year-over-year growth. Our K-12 net revenues, in particular, have been growing more than five-fold year-over-year for over 10 consecutive quarters, which has further solidified our position among the top-tier players in the education sector. We are thrilled to report that growth in paid course enrollments accelerated to 332% year-over-year, from 259% in the prior year. Not only did we maintain our high-speed growth, but we also remained profitable for the eighth consecutive quarter and non-GAAP profitable for the ninth consecutive quarter. Moreover, we generated net operating cash inflow of 528 million, which was 2.7 times that of the second quarter last year, thanks to our exceptional retention for the Spring semester. We plan to execute a profitable growth strategy for the whole year and we will make efforts to prioritize investments in the high ROI traffic acquisition channels, focusing on an online live large-class education business model, and continually enhancing our organizational capabilities.

I would like to emphasize that, this year is very special: It is a year that even the two most important national school exams in China, Gaokao and Zhongkao, were delayed due to the pandemic; It is a year that students and parents further recognize and accept the effectiveness, efficiency and convenience of online education; It is a year that the sector landscape is about to settle down and each online education company strives for its market position. In the second quarter, our sales and marketing expenses were 613% higher than last year, but translated into 2.4 billion gross billings for us. I would also like to remind everyone that a certain number of enrollments in the second quarter last year were from our 49-yuan promotional courses. This year, as we mainly focused on lower 9-yuan promotional courses, which theoretically have a lower access threshold and conversion rate than the 49-yuan courses, we were still able to record an acceleration in paid course enrollments, which really speaks to the remarkable conversion capabilities and operational efficiency of our team. Moreover, the paid course enrollments that we attracted in the second quarter laid a solid foundation for net revenues growth in the third and fourth quarters, which can be seen in our deferred revenues, which hit near to 2 billion. What's more, the soaring gross billings and net revenues this year, along with following retentions from our enrollments, will in turn, drive up our growth in 2021, forming a positive flywheel effect. The first-order ROI already reflects our outstanding operating efficiency and organizational capability. Considering the fact that new users will stay on our platform for more semesters, the Life Time Value they brought will multiply the first-order Return on Investments by times. In short, the more new enrollments that we are able to recruit and then retain now, the higher value they will bring in the future.

Last but not least, in the face of enormous market opportunities, we target full year profitability. As a part of this, we are laser focused on deploying our customer acquisition resources based on

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ROI. Our ultimate goal is to serve students and parents to their satisfaction – which is the core of our decision-making process. In the long run, we will constantly invest in talents, invest in technology, invest in content, invest in services, invest in branding, as well as invest in our culture, all with an eye on maintaining the values that we hold. Through these investments, we aim to redefine the online live large-class format in a way that delivers the quality of a large class, the learning experience of a small class, and the feelings and effects of one-on-one tutoring. Over the past six years, we have broken many records, accomplished multiple breakthroughs, and surpassed many expectations. However, we will still maintain our pragmatic values, and humble and down-to-earth attitude as we continued to build the organizational capabilities of our team and improve the operational efficiency of our company. Joining hands with the major players in our sector, we will spare no efforts to contribute to the equality and fairness of education within our society.

Now, I will pass the call over to our CFO Shannon to walk you through our financial and operational details.

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## Shannon Shen

Thanks Larry, and thank you everyone for joining the call.

Recently, as the new academic year begins, students of all grades are coming back to school. In the past half year, many parents and students have enjoyed first-hand benefits of online education. We are proud to announce that many students of GSX achieved outstanding results in Gaokao and Zhongkao. Our Gaokao candidates ranked top 50, and some even ranked top 5 in provinces including Fujian, Tibet, Heilongjiang, Henan, Inner Mongolia, Ningxia, and elsewhere. Dozens of our Zhongkao candidates achieved full marks in certain subjects. The achievements of these students testify to our exceptional teaching quality, effectiveness in improving learning efficiency, and value in promoting educational equality. Going forward, we will continue to improve our teaching and service quality, expand our investments in technology, and improve learning efficiency.

Now, I will walk you through our operating and financial results, and provide guidance for the next quarter. Please be reminded that all the financial data that I mention will be in RMB terms, unless otherwise noted.

For the second quarter of 2020, we continued to deliver outstanding results. Net revenues increased by 367% year-over-year to 1,650 million. This is our 7th consecutive quarter with net revenues growth by more than 350%. Net revenues from our online K-12 business grew by 412% year-over-year, maintaining above 400% for over ten consecutive quarters. We achieved 2,401 million in gross billings, up by 301% year-over-year and also a new record high in our history. The growth in gross billings was mainly due to our overall excellent student retention and new student recruitment.

At present, we have set up regional operation centers in 14 cities outside of Beijing. We increased our recruitment and training of high-quality tutors to meet the enrollment demands of summer vacation. We are committed to constantly providing better and more customized learning experiences for parents and students.

In the second quarter, we recorded paid course enrollments of 1,567 thousand, which was up by 332% year-over-year. The increase in the first-time users was primarily driven by our effective investments in sales and marketing efforts, and the increase in retention was primarily driven by our high teaching quality and the optimized service that we provided. Specifically, our Spring retention outperformed our expectations. The retention rate of primary and middle school students saw high single digit growth year-over-year. This also helped us in surpassing the milestone of 1.5 million paid enrollments in a single quarter.

Now, let's break down our operations and financials by business lines.

Net revenues from our K-12 courses, mainly offered through 2 brands, Gaotu Ketang and Genshuixue, increased by 412% year-over-year to 1,385 million, and accounted for 84% of net revenues. Net revenues from our K-12 segment once again increased by over 400% year-over-year, and we expect the proportion of K-12 revenue will continue to expand as our main source

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of revenues.

Within the K-12 segment, I want to highlight our primary school business. The growth rate of our primary school segment has been leading all K-12 segments, and the net revenues from primary school classes has increased by more than 500% for five consecutive quarters. This achievement demonstrates the remarkable progress we have made in focusing on our primary school business, and also the continuous improvement in the awareness of our company among primary school parents and students.

Gross billings contributed by K-12 courses rose by 336% year-over-year to 2,196 million.

Paid course enrollments for our K-12 courses increased by 366% year-over-year to 1,496 thousand. The average selling price per K-12 paid course enrollment was 1,468, compared with 1,572 same period last year. The price was mainly dragged down by some short-term courses, which were newly added after Gaokao was delayed this year. Last summer vacation, we offered three customer acquisition promotional courses simultaneously: the 49-yuan courses, the 9-yuan courses and the free courses. This year, in order to synchronize our conversion capabilities with the traffic acquisition pace, we focused more on the 9-yuan courses and the free courses, and no longer provide the 49-yuan courses. As such, last year, we had a proportion of 49-yuan courses enrollments, no longer comparable to this year. Going forward, we will continue to disclose paid course enrollments, which is more specific and one of the most meaningful operational metrics.

Average enrollments per class was consistent with the prior quarter and remained at approximately 2,000 in the second quarter of 2020.

Net revenues from our foreign language, professional and interest courses were up by 238% year-over-year to 260 million, and accounted for 16% of net revenues.

Gross billings contributed by foreign language, professional and interest courses were up by 137% year-over-year to 202 million.

Paid course enrollments for our foreign language, professional and interest courses increased by 69% year-over-year to 71 thousand.

GAAP gross profit margin increased by around 700 basis points year-over-year to 78%. Non-GAAP gross profit margin, which excludes share-based compensation, increased by around 600 basis points year-over-year to 79%.

Selling expenses increased to 1,205 million in the second quarter of 2020. Within that, expenses for branding activities were approximately 35 million, expenses for traffic acquisition were approximately 920 million, and the remaining expenses cover labor, servers, bandwidth, etc. We strategically front-loaded investments of more than 200 million in traffic acquisition for the promotional course recruitment for the third quarter, which generated no gross billings in the second quarter. Even after removing the gross billings contributed by retention, the Return on Investment of pure first-time user acquisition is still around 2. Based on this, if we consider the Life Time Value as a result of high student retention, the Return on Investment will reach 3 or even higher. The firm demand triggered by COVID-19 and parents' deepened understanding of online courses make the 2020 summer vacation a prime time to attract customers. We decisively

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increased our investments in traffic acquisition to achieve a leading position in the industry and gain first-mover advantages.

Research and development expenses increased by 240% year-over-year to 140 million. This rise was primarily due to an increase in the number of content professionals and technology development personnel, as well as an increase in compensation for such staff. Going forward we will continue to expand investments in R&D to further upgrade operating efficiency, which should bring additional leverage.

General and administrative expenses increased to 106 million from 26 million in the second quarter of 2019. The increase was mainly due to an increase in the number of G&A personnel and an increase in related compensation. The fees we paid in the second quarter for independent reviews also contributed to the increase in administrative expenses.

Interest income and realized gains from investments this quarter from cash, cash equivalents, short-term and long-term investments, increased by 505.0% to 24 million, from 4 million in the second quarter of 2019. The increase was primarily due to an increase of cash, cash equivalents and short-term investments, and a realization of gains due to the redemptions of short-term and long-term wealth management investments during the quarter.

Other income increased to 88 million, from 91 thousand in the second quarter of 2019. The increase was primarily due to the value-added tax exemption offered by the government, and was partially offset by the related cost, during the COVID-19 outbreak, which amounted to 89 million.

GAAP net income was 19 million. Non-GAAP net income increased by 133.0% year-over-year to 73 million in the second quarter from 31 million a year ago.

As of June 30, 2020, we had 225 million of cash and cash equivalents, 2,144 million of short-term investments and 572 million of long-term investments, totaling around 2,942 million. That compared with 2,736 million as of December 31, 2019. The decrease of long-term investments is mainly due to the partial redemption of our offshore wealth management in May 2020.

Our accrued expenses and other current liabilities balance was 698 million, increasing from 229 million. This increase was mainly resulted from the consideration of purchasing the Zhengzhou properties, as well as the increase of salary and welfare payables.

Our deferred revenue balance was 1.961 billion. Deferred revenue primarily consists of tuition collected in advance.

Our non-current other payables totaled 64 million, which were payables to purchase the Zhengzhou properties.

Net operating cash inflow for the second quarter of 2020 was 528 million, 172% increase from 194 million in the second quarter of 2019. This figure, included the 158 million tax paid to the State Tax Bureau during the quarter. Our capex totaled 98 million this quarter, including 22 million installment for the Zhengzhou properties, and 76 million for office space renovation funds and other fixed assets.

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In addition, we repurchased approximately 1.1 million ADSs for approximately USD 40 million, representing an average cost of 35.1 dollars per ADS. On the premise that the operating cash flow continues to be positive, we believe the share repurchase plan helps to improve shareholder value, and shows the long-term confidence of our company's management.

With that, I will now provide our business outlook. Our net revenues for the third quarter are projected to be between 1.936 billion and 1.966 billion, representing an increase by 247.6% to 253.0% on a year-over-year basis. These estimates reflect our current expectations, which are subject to change.

Operator, now we can start the Q&A session. Thanks.

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## Question and Answers

### Operator

We will now begin the question-and-answer session. (Operator Instructions). The first question is from Gregory Zhao of Barclays. Please go ahead.

### Gregory Zhao

Alright, thank you. Good evening, Chen Laoshi, Shannon, Sandy. Thanks for taking my questions. Congratulations on a strong quarter. So the first question is still about the market competition. So we note that your peer companies have been very aggressively marketing since early this year, especially several private companies, they also announced some new fundraising. So would you please help us understand the current competitive landscape of China online tutoring market? And any update of the summer promotion would be helpful.

And the second one is about our sales and marketing expense. Based on my calculations, I can see that sales and marketing per enrolment sequentially decreased in the second quarter, showing some improvement in the marketing ROI. So are there any particular reasons? And how shall we think about the trend in Q3 and the second half?

### Larry Chen

Thanks, Greg. As to competitive landscape, I have the following views. Firstly, online education is still in its early stage, so as we can see a considerable amount of capital is flowing into the sector, which is helping to further accelerate its development.

Secondly, the customer acquisition cost increased significantly this summer in comparison with last summer. At this very moment, we can see the biggest private players have raised the new rounds of funding in the hundreds of millions of U.S. dollars, and in some cases, up to maybe probably USD 2 billion. According to third-party data, the top 10 players in the market have spent an aggregate amount of over 10 billion on traffic acquisition and branding activities in summer, just in July and August.

Thirdly, the online education value chain is pretty long. So just to focus on the essence, focus on the quality, or focus on the operational efficiency, we believe that just mostly focusing on revenues and size is not a sustainable way to achieve long-term success. Recently, we have seen many companies promote how large their student size is, or gross billing sizes are, but very few mentioned the cost and expenses they've incurred.

For an online education company, if it isn't profitable when small, it will likely be over-burdened when it scales up. According to some market views, some players that aggressively expand their student sizes and gross billings, might see annual losses of over 7 billion RMB.

Our core strategy is always to focus squarely on the online live large-class-based model, and target the profitable growth for the whole year, where we'll continue to enhance our

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organizational capabilities and high ROI decisions. And we believe that time will tell who the winners are in this space.

Fourthly, we always remind ourselves that we should concentrate on what really matters over the long term, which is customers. We will always focus on our customers, not the competitors, and we believe as we serve each customer well, funding will come naturally. That's one of the reasons why we were able to achieve 528 million in net operating cash flow, and also the reason why we were in position to buy back shares of the company in May.

Last, but not least, this summer Genshuixue and Gaotu Ketang both delivered solid results, and therefore, we firmly believe that we will achieve our full year revenue targets. Thanks.

### **Shannon Shen**

Hello, Greg, I'm going to take your second question. So about the sales and marketing expense per enrollment decrease in this quarter, so firstly, let's recap what happened in the first quarter in 2020. So in the first quarter, as we mentioned on our Q1 earnings call, a majority of the enrolments are coming from the first-time users. And for the first-time users, like we usually need to pay attention and spend more energy to convert them to sign up for our paid course enrollments.

So then in the first quarter, if we divided the sales and marketing expenses by the paid enrollments, we basically had a customer acquisition cost around 970 RMB. And in the second quarter, usually, the second quarter is one of the largest retention seasons in the year. So especially in April and in May, students in the Spring semester, they will be signing up for the next semester in summer. So that's why we have a proportion of gross billings and enrollments actually come from the existing students. And that's why we always say for K12 education, it is an industry that can accumulate loyalty and long-term customers.

So for our existing students, basically, the customer acquisition cost is zero, and the cross-selling, retention, and word-of-mouth referrals are the key to our continued customer acquisition cost. So then the key is to provide the best service to the students, and to achieve the most excellent cross-selling, retention and word-of-mouth referral. Only leverage this that can contribute to our long-term success, and because we have this part of enrolments coming from the existing students, that actually further lowered the weighted average customer acquisition cost in our second quarter.

And if we look at the seasonality across the year, the first quarter and the third quarter will be a quarter that majority of the students are the first-time users. And for the second quarter and the fourth quarter are the biggest retention seasons, so we will see the customer acquisition cost in the second quarter and in the fourth quarter to be significantly lower. Especially for this year, we do foresee the weighted average customer acquisition cost to be further lowered in the fourth quarter this year. Hope this address your question, thanks.

### **Gregory Zhao**

Thank you, very helpful.

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## **Operator**

The next question comes from Alex Xie of Credit Suisse. Please go ahead.

## **Alex Xie**

Hi management, thank you for taking my questions. Congratulations on the very strong set of results. And I have 2 questions. Firstly, I think the management, you have discussed the SEC investigation request and your own internal review. Can you share more color on the progress of the investigation and the internal review? And particularly, I think for Larry, you have experienced all these things in another great education company, New Oriental, back in 2012. What's your experience from that, and are you confident at this time?

And secondly, I'd like to ask about the attending enrollment in the summer semester and autumn semester. Do you have any target or color to share? I think you have disclosed that in the spring semester and that's your attending enrollment exceeded one million. So these are my questions. Thank you.

## **Shannon Shen**

Thanks, Alex. About the SEC investigation, so in the past quarter, we have received about at least 12 short-seller reports, and we have grabbed public eye because of this unique experience. At this stage, we are unable to disclose too much details of the investigation, but here we wanted to share some of our feelings.

After being short attacked, we have been continuously harassed by short-sellers. We keep receiving phone calls, emails and some of them keep sending malicious Tweets and kind of like attacking us all the time. And whenever there is any negative news from other companies, even if it is completely unrelated to us, we were linked to the bad image. As a company, we need an authority that everyone can trust to prove the integrity of our company, and we no longer want to be in that position anymore. So SEC and the investigation team are actually the best judges everyone can trust.

So unlike some of the investors may have predicted, to some extent, we actually welcome the investigation, and we have faith and expectations on the outcome. And frankly speaking, the investigation process is invasive, stressful, very intense, and costly expensive. But going through all these procedures, we highly respect the professionalism of the investigation team.

We think all parties should play their own duties. SEC is taking care of the interest of all investors, and our audit committee is responsible for improving corporate governance. Lawyers and forensic accountants are carrying out the whole investigation process. And our obligations as management team, our responsibility is to fully cooperate and properly disclose this matter with on the advice of our legal counsel. So that's how we can build a trust in this type of market.

Therefore, actually, my team had a 24-hour rule, which means that we should try to give feedback within 24 hours for any information needs raised by the investigation team. We hope to establish a completely transparent communication mechanism. So we hope the market knows

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what's going through with us, and we are ready to take the potential short-term pressure in exchange for a long-term trustworthy relationship.

And we do think, and we highly believe, to voluntarily disclose of this investigation itself actually shows the strong confidence of our management team, and it shows the high level of our corporate governance.

**Larry Chen** (Speaking Chinese)

(Translated) Thank you, Alex. So I will -- I'll speak in Chinese, so as better to deliver my emotions. When we establish our company, we already --

**Operator**

Excuse me, I'm sorry. Could you please move the speakerphone? I cannot hear you. This is the operator.

**Sandy Qin**

Okay.

**Operator**

Thank you.

**Sandy Qin**

Thank you. (Translated). So Alex, I will speak in Chinese, so it can better deliver my emotions. When we establish the company, we already defined the culture and the foundation of this firm. When a great firm is always questioned and doubted about faking data, internally, we feel a lot of anger. As early as the beginning of May, we tried to figure out if there's any notary institutions we can find to do interviews of our students, and then we do the recordings to prove ourselves - but it's not that doable.

I began to recall what we did in reacting to this short attacks when I was back in New Oriental. So we started to communicate with the auditing committee. I can't tell -- disclose the specific date for now, but our auditing committee used the same internal inspection method as what we did in New Oriental. And also we started pretty early, and after quite a time, that is when SEC investigation started.

Frankly speaking, when the SEC started the investigation of us, we feel very happy and pleased. Just as Shannon has mentioned, the investigation from SEC and from our auditing committee, those are the best way, and only way, to prove a company's integrity. So we welcome that a lot.

And also, as Shannon mentioned, we have a 24-hour rule, so we try to be open and transparent; we try to provide the data, deliver and resolve the questions very fast. As you know, we have experienced over 10 times of short attacks, so a lot of things are still ongoing, and at this stage, we haven't disclosed more. We need some more time and we believe time will tell.

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## **Shannon Shen**

Thanks, Alex. I'm going to address your second question. So about the summer and fall concurrent students, so it is always a golden time for acquiring new students, every summer vacation. On account of the pandemic, online education has gradually gained more acceptance of parents with good learning results, convenience, safety, and these all have been well proved. Therefore, this summer was an unprecedented good time for customer acquisition. When we worked out a plan for this summer, we did not only plan for the second half of the year, but also for the next year in growth.

So we strategically invested in both branding and traffic acquisition and like other things in technology, etc. Firstly, about the branding, we started our branding campaign for the first time this quarter. We cooperated with some TV shows like Jixian Tiaozhan, Zhongguo Haoshengyin and a self-produced TV reality show with iQiyi called Qinaide Xiaokezhuo. Now, the Jixian Tiaozhan has finished its broadcasting and based on its audience ratings conducted by CMS 59, it ranked number one among two major networks for weeks running. And Qinaide Xiaokezhuo is an extremely heartwarming show with topics really closely related to online education.

So when we do all those branding campaigns, we choose our partners and programs very carefully, and we closely monitor the synergy between the brandings, and see whether it can further lower our customer acquisition costs.

And secondly, and also I want to highlight here, it's like we have adopted multiple channels to acquire traffic, and have been exploring innovative ways. And if we can recall last year, a lot of other online education companies were using the 49-yuan model to recruit new students. We were probably the only one company that used the 9-yuan promotional class model. We were confident that because the 9-yuan class model can give us a lower cost on traffic acquired, maybe just as half, or even lower than half, compared to the 49-yuan class.

But because we have confidence in our teaching quality and the service of our tutors, we are confident that the conversion rate from -- even from 9-yuan class shouldn't be too much lower than the 49-yuan class. And that's why we were very successful in last summer, which provides us with a fairly low customer acquisition cost.

And so for this year, we do see a lot of other companies starting to leverage the 9-yuan class model as well, but for us, the model is well polished for around 15 months, and it's the most successful model for us. So we still see we did a very good job on our summer campaign, but frankly speaking, this summer campaign, or this summer vacation is relatively shortened because the delay of Gaokao and Zhongkao. So we have reduced one round of the classes.

So the main goal for this summer was to -- is to recruit more students in the fall semester. And we do expect a big jump in the fall semester concurrent students, but because the recruitment is still ongoing, so we may probably communicate that number when the recruitment is done.  
Thanks.

## **Alex Xie**

Thank you very much, very helpful.

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## **Operator**

The next question comes from Mark Li of Citibank. Please go ahead.

## **Mark Li**

Hi Larry, Shannon and management, thank you very much and congrats for the results. I want to ask for actually, for Q3, I think we do have a pretty strong revenue growth momentum. How about on the margin front? Because I think you mentioned we may enjoy lower customer acquisition costs, but at the same time, I see that peers are also heating up in the second half of the summertime. Hence, I think any color or any of your strategies for the margin or the selling and marketing management could be appreciated.

And secondly, I want to ask -- I think you mentioned previously, this year, you will start to do a bit more lower-price classes, and also the locally-differentiated classes, I think, for the various regions. I want to know how is the progress for the low-price classes and how would that help for your more tier expansion? Any color on this side as well. Thank you.

## **Shannon Shen**

Thanks, Mark. For the margin, in the short-term, our margin can be digested from a few layers. Firstly, let's look at the gross profit margin. Our GP margin will stabilize with our class size gradually fixes; probably it will fluctuate with our course scheduling but overall, our GP margin will be stable with 1% or 2% fluctuation.

Secondly, let's look at the OP margin level. We will still generate operating leverage from our R&D and G&A expenses, with our net revenue continuing to expand. And the biggest driver for our OP margin change will be our seasonal fluctuation on the sales and marketing expenses. And actually, the S&M shows distinct seasonality. Let's use this quarter as an instance. So our Q2 non-GAAP margin was a negative -- around negative 6% in the second quarter. The main cause behind the loss was our advanced traffic acquisition in the summer semester in Q2.

As I just mentioned in the prepared remarks, the sales leads we acquired by the end of May until June amounted to more than 200 million, were actually for the promotion classes scheduled in July and in August, which basically means this money we spent in the second quarter, there's no gross billing that can match, and the related gross billing will only be received in the third quarter, and the revenue will be recognized in the third quarter and in the fourth quarter. So if we actually move this 200 million from the second quarter to the third quarter, then they will still be having over 100 million of gross profit margin from non-GAAP perspective. That gives us an over 7% of positive OP margin.

But I mean, from the whole year's perspective, this is not important, just moving the sales and marketing from one quarter to another quarter. That only depends on how we want to enjoy the first-mover advantage, and we want to book the students' and parents' time in advance, so we can have a better -- we can have a lower customer acquisition cost in the long run.

And from another perspective, if we just look at the spring semester, which means from March to May, if we just look at the spring semester, our OP margin can be as high as 15% or even higher.

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So the more meaningful way would be look at the margin on an annual basis, other than just look at it in just a certain quarter. So our operating profit will be released largely in Q1 and Q4, and with a lower margin in Q2 and Q3. That's just because of the seasonality. Thanks.

And for the promotional classes, as I just mentioned, so last year, we have 3 types of promotional classes, the 49-yuan and the 9-yuan, and the courses totally for free. And we kind of like did AB test for all kind of promotional classes, and we still think the 9-yuan is the best model for us, at least for this year. As I just mentioned, that gives us a lower traffic acquisition cost, just as half or even lower than half of the 49-yuan traffic acquisition cost.

But because our strong organizational capability, we train and recruit our tutors in advance, and we recruit the best instructors on the market. So we can still maintain a relatively high conversion rate, that gives us a lower customer acquisition cost and a high ROI. We kind of like compare the ROI in the market in the second quarter. We still enjoy -- our ROI level is still leading the whole industry.

So in the future, we will still closely monitor what's going on in the market, and what's going on with parents and students, and still be very proactive to design our promotional classes, and have the promotional classes to serve our students and parents to their best satisfaction.

And for the enrollments, this quarter, we still have over 50% of our paid enrollments coming from lower-tier cities. And this is our 5th consecutive quarter that enrollments from lower-tier cities are higher than the first and second-tier cities, which we think completely makes sense because with the pandemic, then the lower-tier cities' parents, they have a higher acceptance level of online education. And they are eager to find the best teaching resources that can actually match the first and second-tier cities for their children.

And as I just mentioned in my prepared remarks, we do have a lot of students, they live in far away, or even third-tier cities or fourth-tier cities. But they follow the online education; they learn from the best teachers, and they still have a really high score in Gaokao and Zhongkao. So I think that's the value of online education as well. Thanks, Mark.

**Mark Li**

Thanks, Shannon. I just want to quickly ask also, I think last quarter, we mentioned we would launch more localized tailor-made classes (Speaking Chinese).

**Shannon Shen**

Right.

**Mark Li**

I want to know any update we have on that front.

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**Shannon Shen**

Yeah, we have established around 14 operating centers outside Beijing that can better cover more customized and localized curriculum. It is still ongoing, and we do think -- so based on the technology we have and the data we have, we can design more of like a one-on-one level curriculum and more personalized courses like that we can offer to localized students, and help them to better -- have better outcomes in their tests.

**Mark Li**

Many thanks, very helpful.

**Operator**

We have a question from Maggie Zheng of Haitong. Please go ahead.

**Maggie Zheng**

Thank you for taking my questions. Congratulations on your impressive results. I have 2 questions. The first is regarding the -- actually, I see you are still expanding your operational centers across China, and have 13 operation centers at the moment. So may I ask your number of teachers and tutors at the moment?

**Shannon Shen**

Thanks, Maggie. Till now, we have over 10,000 tutors that serve our students in the summer campaign. And in the future, we will continue to recruit the best tutors and provide the best service to our students.

**Maggie Zheng**

Okay. And my second question is related to the star teachers. May I know the contribution from the top-10 teachers from this quarter?

**Shannon Shen**

So this quarter, the net revenue contributed from our top 10 instructors was 34.9%. Since our IPO, the contribution of our top 10 instructors has been gradually declining, declining every 6 months. So the slight increase in the second quarter versus the first quarter was mainly because after the spring courses end in early June, only some instructors who teach foreign language and other professional courses contribute to net revenue.

So we expect, after summer vacation, because we have a lot of new instructors, will start formally teaching. And the contribution from our top 10 instructors will continue to decline. And actually, as for our current instructor structure, we have accumulated a certain number of top-notch instructors. And our course development systems are improving over time, so we don't really think the concentration of our top instructors in net revenue will be a major risk in the future. Thanks.

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**Maggie Zheng**

Okay. Thank you so much.

**Operator**

The next question comes from Felix Liu of UBS. Please go ahead.

**Felix Liu**

Thank you management for taking my questions and congratulations on the good results. I have 2 questions. One is on the sales and marketing side. I know we recently launched a branding advertisement in this quarter. So can management share the sort of early effectiveness of this strategy? And also we know that some of our competitors are using more OMO to sort of tackle the online market. Is it a strategy that we might consider sometime in the future, given our, you know, history with New Oriental?

My second question is on tax. I notice we have quite a big tax benefit this quarter. Can management help us understand the reason behind it?

**Shannon Shen**

Thanks. As I just mentioned, this is the first time we started to try our branding advertising in a higher-level scale. And we were very careful when we choose our partners and programs. So as I just mentioned, we tried Jixian Tiaozhan and Zhongguo Haoshengyin. These are the 2 TV shows that have stable audience and have a constant reputation for 6 years. Although it may not be really new and may not be very -- attracting like Chengfengpoliangde Jiejie and other programs, this program does provide a stable audience that -- and the programs themselves actually fit our brands.

And also we choose like the self-produced reality shows with some online platforms that more-younger-generation parents, they are very happy and more accepted on this method of branding. So but still, we will be very carefully when we try these brand activities. We will closely monitor all the figures there, like the exposure, the reputation and the audience ranking, and see how people link this brand to our brand, and continually observe our data from the traffic acquisition side; and to see whether this branding will help further lower our customer acquisition cost.

And your second question about the OMO strategy from other companies, so as we keep mention in the past couple of quarters, I think the reason why we did a good job until now is because our focused strategy. So when we are facing a huge market opportunity here, being focused can help us concentrate all of our energies, all of our resources, in this channel and that helps us to outperform. So at least right now, we will still be focusing on the online large-class business model and keep improving our organizational capability to serve more students.

And your third question is about our tax benefits recognized in this quarter. We reported around RMB 68 million tax benefits this quarter. This is mainly due to the new rules on share-based compensation push-down policy implemented in Beijing. The income tax expenses recorded in 2019 was based on the best estimates by the end of 2019.

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In November 2019, Beijing State Tax Bureau published an instruction on income tax, and mentioned the tax treatment for share-based compensation push-down. A part of the cost incurred, satisfying certain conditions, can be deducted from the pretax income.

However, during the tax filing at the end of 2019, there is no actionable details that we can use. So upon consultation with a professional tax advisor, we did not enjoy the income tax deductions for this matter last year. But in the second quarter in 2020, we have successfully communicated with the local tax administration to reclaim this part of tax deductions during the annual tax filing.

And based on the accounting standard codification, a change in judgment that results in subsequent recognition, or change in measurement of a tax position, taken in a prior annual period should be recognized as a discrete item in the period in which the change occurs. So that's why we recognized the tax benefit this quarter.

So this is, at some level, a little too complicated. So I may as well explain it in Mandarin in favor of people who are familiar with the Chinese taxation law. (Speaking Chinese).

**Felix Liu**

Thank you, Shannon. And may I just follow up -- so this will be the tax benefit; this will be for the rest of this year and for next year, we should come back to normal. So what is the sort of reasonable tax rate that we should assume going forward on the mid-to-longer-term basis?

**Shannon Shen**

Right. This is a really good question. So from the VAT side, because of the COVID-19, we do enjoy the VAT exemption for the whole year. So that's why you will always be seeing an income in other income section, and that's basically all the K-12 after-school tutoring business, we all enjoy the same tax benefits.

And from income tax, when we calculate the tax expenses, we use the annual effective tax rate because we have a variety of entities in China that enjoy different level of tax benefits. So currently, the best estimation from now, the effective tax rate for this year will be around 12% to 15%.

**Felix Liu**

Okay. Thank you very much.

**Shannon Shen**

Yes, sorry. And for the next year --

**Felix Liu**

Okay.

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**Shannon Shen**

Okay. Okay. Thanks, thanks. I hope that addressed your questions. Thank you.

**Operator**

Thank you. This concludes our question-and-answer session. I would like to turn the conference back over to Sandy Qin for any closing remarks.

**Sandy Qin**

Okay. Thank you, operator, and thank you, everyone, for joining the call today. If you have any further questions, please don't hesitate to contact us or the company directly. Please feel free to subscribe to our newsletters on the company's IR website at [gsx.investorroom.com](http://gsx.investorroom.com). Thank you very much.

**Operator**

The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.

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