OneSmart International Education Group Limited (ONE)
Q2 Fiscal Year 2021 Earnings Conference Call
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Executives:
Ida Yu, IR Senior Director
Steve Zhang, Chairman and CEO
Greg Zuo, CFO and CSO

Analysts:
Sheng Zhong, Morgan Stanley
Felix Liu, UBS
Unidentified Analyst, Hito International

Presentation

Operator: Hello, and welcome to the OneSmart Second Quarter Fiscal Year 2021 Earnings Conference Call. (Operator Instructions). After today's presentation, there will be an opportunity to ask questions. (Operator Instructions). Please note, today's event is being recorded.

I now would like to hand the call over to Ida Yu, Investor Relations with OneSmart. Please go ahead, ma'am.

Ida Yu: Thank you, operator. Good morning and good evening, everyone, and thank you for joining OneSmart International Education Group Limited's Second Quarter 2021 Earnings Conference Call. The Company's earnings results, as well as supplementary slide presentation, were released earlier today, and are available on the Company's IR website at ir.onesmart.org.

Joining me on this call are Mr. Steve Zhang, Chairman and CEO, and Mr. Greg Zuo, our CFO and CSO.

I will remind you that this call may contain forward-looking statements made under the safe harbor provisions of the Private Securities Litigation Reform Act of 1991 -- 1995. Such statements are based on 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, which may cause the Company's actual results, performance or achievements to differ materially from those in the forward-looking statements.

Further information regarding these and other risks, uncertainties and factors is included in the Company's filings with the United States Securities and Exchange Commission. The Company does not undertake any obligation to update any forward-looking statement as a result of new information, future events, or otherwise, except as required under law.

With that, I will now turn the call over to Steve. Please go ahead.

Steve Zhang: Thank you, Ida. Hello, everyone. We are pleased to see the return of strong sales growth despite the challenges in offline operations due to the COVID-19 resurgence in certain cities around the Chinese New Year in January and February 2021.

Our Go Premium strategy of execution is well on track, with further enhancements made on products, learning centers, services, and premium brand awareness. The upgraded and optimized product offerings have started to contribute to the remarkable top line growth, which will lead to improvements in profitability in the following quarters.

Our continued investment in technology benefit both online and offline operations. We have revamped and built a strong digitalized operation platform to support standardization, efficiency and customer satisfaction. In addition, we are making great efforts on premium brand building and local marketing to reach our target customers more effectively.

With that, I will now turn the call over to Greg, who will provide you more details of our strategic achievements and the updates on the company performance in Q2. Greg, please go ahead.

Greg Zuo: Thank you, Steve. Hello, everyone. Thank you for joining us on today's earnings call. I would like to start with comments on the overall performance before I go through individual presentation slides, which were uploaded onto our company website earlier today.

In our new phase of growth post-pandemic, we are delighted to see the return of solid top line growth driven by strong demand for our core 1on1 tutoring products, our improved premium products and services and our enhanced student acquisition approach. Following the 20%-ish year-over-year growth in fiscal Q2, our company-wide cash sales growth has continued to trend up, recording more than 100% year-over-year increase in the fiscal Q3 to date.

The Go Premium strategy that we launched in the beginning of fiscal 2021 has boosted our revenues for OneSmart VIP 1on1 program to grow driven by the year-over-year increase in volume, i.e., the consumed class units and price.

In addition to tutoring, our value-added premium services of personalized school admission planning and in-person caring distinguish us from other education service providers. Encouraged by the initial success of the Go Premium Strategy, and justified by increased revenue profile, we will continue to invest in our products, teachers' credentials, learning centers and build our premium brand.

In the recent months, we have completed the upgrades of our nationwide learning centers, improved our teachers’ profiles, launched premium brand campaigns, and built the digital operations platform. These efforts largely enhance customer satisfaction, leading to the growth in new students enrolled sequentially.

I will now turn to our earnings presentation slides. I first start with our operational achievements related to Go Premium Strategy as illustrated on Page 7 of the presentation. First, we have upgraded teacher profiles, learning centers, with value-added premium offerings in personalized school admission planning and in-person caring (inaudible).

Consequently, as of April 2021, our nationwide year-over-year growth in average price per class unit consumed is 23%, 7%, and 11% for OneSmart VIP, HappyMath, and FasTrack English product respectively.

Our conversion rate of new customers from leads doubled from 11% to 23% during April 2021, after the launch of digitalized customer service platform.

Second, by the end of April 2021, we newly opened and upgraded 14 flagship VIP learning centers, to provide a premium learning center experience. Third, since December 2020, we have conducted a series of premium branding campaigns and local marketing in the key cities, which largely enhanced OneSmart's premium brand awareness among target families in these cities and boost the number of new students enrolled.

In the fiscal Q2, the number of new students enrolled from local marketing channels increased by 19% from the fiscal Q1. We have strictly followed the necessary and appropriate guidelines continuously to protect the safety and health of all our students and employees. In the fiscal Q2, we introduced contactless tutoring services to set up an industry-leading high standard of safety and cleanliness in offline learning centers, thus to further protect our teachers and students in response to the COVID-19 resurgence in certain cities.

Please turn to Page 8 for our latest performance trend. We focus on the key data of cash sales as it provides latest status of our business which gives visibility of future growth.

In the fiscal Q2, December to February, despite the COVID resurgence impact in certain cities around the Chinese New Year, cash sales still achieved a double-digit year-over-year growth. The key drivers for such accelerated growth include: First, students are back to normal study schedules to boost post-pandemic recovery for offline centers. Second, Go Premium strategy is building up customer satisfaction and premium brand perceptions. And third, the successful launch of VIP premium products.

Heading into fiscal Q3, our company-wide cash sales year-over-year growth has continued to trend up, recording 119% and 102% in March and April 2021 respectively. Q3 to date cash sales have grown more than 100% year-over-year, mainly attributable to a strong demand for our 1on1 services and the success of our Go Premium strategy. We are optimistic about the continuous growth trend in the future.

In fiscal Q2, our net revenues grew by 5.2% year-over-year to RMB932 million. On Page 9, by breaking down, we achieved net revenues of RMB735 million from OneSmart VIP business, accounting for 78.9% of total net revenues, increasing 7.4% year-over-year and 51% sequentially.

Net revenues from young children education business were RMB155 million, accounting for 16.6% of total net revenues. Net revenues from OneSmart Online were RMB32 million, accounting for 3.5% of total net revenues.

I will elaborate more on our operational progress on OneSmart VIP business in the next few pages.

Please turn to Page 10. On a like-for-like basis for 1on1 program, in the fiscal Q2, cash sales increased by 23% year-over-year, and net revenues grew by 22% year-over-year, driven by a 12% increase in class units consumed and a 9% increase in average price per class unit consumed.

In March and April 2021, our cash sales improved by 119% year-over-year for OneSmart VIP 1on1 program. This is a combined result of robust demand for the highly effective 1on1 tutoring product as exam schedules have normalized; and two, the improved customer experience of our upgraded products, centers and services; and three, our proactive marketing campaign to build brand to attract new customers; and four, the relatively low comparison base due to COVID outbreak in the same period last year.

Please turn to Page 11. On top of our score-improving 1on1 tutoring, our value-added premium services of personalized school admission planning and in-person caring are highly appreciated by customers. Under the personalized school admission planning, we provide the timely and in-depth analysis on school admission policy, the assistance in setting reasonable academic goals agreed by students and parents. The full cycle is a standardized quality control process, including constantly tracking the progress, providing feedback reports and making proper adjustments to achieve the goals.

Furthermore, our in-person caring service is designed to bring out power learning of each student. Power learning includes learning motivation, learning aptitude and learning perseverance. As Steve mentioned earlier, OneSmart is committed to put power learning first. We train our students, teachers and advisors to inspire students to realize their full potentials. This is the essence of education that we believe in.

For the past few years, we have continuously invested in technologies to revamp and build a strong digitalized operating platform, which is highly customized to our unique 1on1 business model both for front-end and back-end. Today, I am also pleased to provide an update how the technology supports Go Premium Strategy as shown on Page 12.

First, the platform delivers high efficiency in customer acquisition and full cycle management. Second, the platform enhances professional premium tutoring and other value-added services with touch rate to improve customer satisfaction. Third, the platform simplifies class scheduling management to generate synergy across learning centers and improve transparency. We believe the constantly-evolving technology applications will further support our service standardization, operational efficiency, and in return, to enhance customer satisfaction.

As shown on Page 13, by the end of April 2021, we opened and upgraded 14 flagship VIP learning centers to provide a premium learning center experience. Students' performance, aside from teaching quality, relies on a variety of factors, such as environment, attendance, and concentration. Our unique high-tech enabled flagship learning centers offers a spacious, safe, and fun environment to help students learn more effectively.

Our upgrades include facial recognition and fingerprint systems for security, enhanced lighting, ventilation, and furniture for better safety and health, and innovative comfortable facilities for a more holistic learning experience.

In the first 6 months of fiscal 2021, Elite VIP program accounted for 11% of the cash sales from OneSmart VIP business.

In the fiscal Q2, we also further enhanced our local marketing approach, just before the peak seasons which are Q3 and Q4. As we have shared with our investors previously, we leverage our offline center network to effectively reach target families and improve our brand awareness. Page 14 summarizes how our marketing campaign works to acquire new customers through local marketing activities, by enhancing professional brand influence through public seminars, and our increasing brand awareness and extending customer reach around learning centers.

In fiscal Q2, new students enrolled from local marketing channels increased by 19% from the prior quarter. Cash sales from new customers and referrals contributed 55% of total cash sales, up from 47% in the same period last year, primarily due to the effective customer acquisition approach from local marketing channels, and enhanced customer satisfaction.

Now, move on to profitability snapshot of OneSmart VIP business on Page 15. We are pleased to see Q2 fiscal year 2021's revenues and profit margins improved with quarterly gross margin of 45% and BU level operating margin of 6% during the quarter. This encouraging recovery is primarily attributable to strong demand for premium 1on1 tutoring to support business model; our strong localized teaching R&D capabilities to adapt to evolving operational environments; and three, strategic expansion plans to focus on scale-up of top 20 cities to drive profitable growth.

We are pleased to see the start of gross margin recovery during the quarter driven by strong top line growth. However, our fiscal Q2 P&L results have not yet reflected recent strong cash sales momentum, as it typically takes a couple of quarters for sales to translate into class consumptions, i.e., revenue recognition in our business. Our peak season for revenue recognition is typically Q3, which is March to May, and Q4 which is June to August, due to intensive study and exam schedules in China.

In the meantime, we need to invest in our brand in advance to support our Go Premium strategy. As a result, we observed temporary operating margin pressure in fiscal Q2. With the strong cash sales trend and significantly higher new sales in average price per class unit consumed, we are optimistic about our future performance.

Lastly, we are aware of, and closely following, the regulatory development. We have continued to promote high standards in providing better learning environment, quality and services to our students. However, we have limited exposure in Beijing, which contributed about 5% of our net revenues in fiscal 2020.

With that, I will turn the call over to Ida. Ida, please go ahead.

Ida Yu: Thank you, Greg. In the second quarter of fiscal 2021, cash sales totaled RMB939 million, increasing 44.2% and 18.9% from the same period of fiscal 2019 and fiscal 2020, respectively. If excluding the impact of 1on3 program, cash sales increased 66.8% and 17% from the same period of fiscal 2019 and fiscal 2020, respectively.

Net revenues were RMB932 million, an increase of 5.2% from RMB886 million during the same period last year. Excluding 1on3 program, the net revenues showed an increase of 11.4% from fiscal Q2 of 2019. The year-over-year increase was mainly attributable to the growth in average price per class unit consumed, driven by a strong recovery in fiscal Q2 and our Go Premium strategy post-pandemic.

Cost of revenues increased by 2.5% year-over-year to RMB543 million. The year-over-year increase was mainly attributable to higher staff cost relating to an increase in class units consumed and enhanced teacher profiles, and additional costs for learning center upgrade and online teaching operations to support our Go Premium strategy.

In the fiscal Q2, gross profit was RMB389 million, a year-over-year increase of 9.2%. The gross margin was 41.8%, up from 40.2% in the same period last year.

Non-GAAP selling and marketing expenses, which excludes share-based compensation expenses, were RMB289 million, accounting for 31% of net revenues or 30.7% of cash sales, an increase of 46.9% from RMB197 million, accounting for 22.2% of net revenues or 24.9% of cash sales during the same period last year.

The year-over-year increase was primarily due to the strategic branding and offline marketing activities to reach target families in the execution of Go Premium strategy, as well as the requirements of running major marketing campaigns in a timeline ahead of the Q3 and Q4 peak tutoring seasons, and the relatively low spending due to limited offline marketing activities during COVID-19 outbreak in fiscal Q2 last year.

General and administrative expenses decreased by 1.8 % year-over-year to RMB211 million. The decrease was primarily due to our expense control policy to keep a healthy financial condition during the post-pandemic recovery. Non-GAAP G&A expenses, which excludes share-based compensation, were RMB185 million, accounting for 19.8% of net revenues, compared with 20.1% of net revenues during the same period last year.

Operating loss for the quarter was RMB110 million, compared with operating loss of RMB[50] million in the same period of last year. Non-GAAP operating loss, which excludes shared-based compensation, was RMB85 million, compared with non-GAAP operating loss of RMB18 million during the same period of the prior fiscal year.

Operating margin for the quarter was negative 11.8%, compared with negative 6.2% in the same period of the prior fiscal year. Non-GAAP operating margin was negative 9.1%, compared with negative 2% during the same period last year. The decrease of the margin was mainly due to the revenue improvement, offset by the increased investments in teacher profiles, learning centers and increased sales and marketing activities to support the Go Premium strategy.

Let me now move on to cover some other key financial points for the second fiscal quarter of 2021. Capital expenditures for Q2 were RMB69 million, a year-over-year increase of 1.2% from RMB68 million in the same period last year. Capital expenditures accounted for 7.4% of net revenues in Q2, representing a year-over-year decrease of 30 basis points from 7.7% in the same period last year. The slight increase in capital expenditures was mainly due to learning center upgrade and new opening of OneSmart VIP flagship centers.

OneSmart's prepayments from customers' balance, which represents cash collected from enrolled students for courses and recognized proportionately as the training sessions are delivered, reached RMB2.73 billion at the end of fiscal Q2 2021, representing a year-over-year increase of 14.5% from the end of fiscal Q2 last year.

As of February 28, 2021, the Company had cash and cash equivalents, restricted cash and short-term investments of RMB1.02 billion. The decrease from cash balance as of November 30, 2020, was mainly due to management's decision to prepay some of company debt, which was strategically built up during the pandemic period last year. The continuous strong cash sales helped further reduce the requirements of large cash balances. The total balance of debt decreased by RMB419 million during fiscal Q2.

Revenue guidance: Based on the latest estimates, we expect to generate net revenues of RMB950 million to RMB1 billion for the fiscal Q3 of 2021, equivalent to 27.5% to 34.2% increase year-over-year. We expect our full year revenue to reach above fiscal 2019 level.

However, this outlook represents OneSmart's current view, which is subject to change.

This concludes our prepared remarks. I will now turn the call over to the operator and open for Q&A. Operator, we are ready to take questions.

Questions and Answers

Operator: Yes, thank you. We will now begin the question-and-answer session. (Operator Instructions). Sheng Zhong with Morgan Stanley.

Sheng Zhong: I have 2 questions here. The first one is glad to see the Go Premium strategy build more well. And would mind to give us more color about the elite 1on1 program, so margin now, and when do you expect it to ramp up?

And secondly is you have a very strong cash revenue growth, but in the meantime, we also see the sales marketing is also a little bit higher than the cash sales revenue growth. So can you share some observation on the customer acquisition cost trend now from the market?

The last question is are you -- you repaid some bank loans, so cash balance now is now lower. And there are a lot of concerns on the regulation, especially on the tuition fees supervision. So can you share your view about how this regulation could impact your balance sheet and operation?

Greg Zuo: Thank you. For the first question regarding the Go Premium strategy, what is the latest update on the elite VIP products? So as you noticed, we have provided lot of details in today's earnings call regarding the well progress program that we launched. The investment, this program addressed better the customer needs by providing value-added services. The satisfaction rate helped us to generate pretty robust results, evidenced not only the cash sales growth, the ASP growth, and additional purchase size growth, which we provided consistently the last few quarters. So we continue to be very confident about the future of this strategy.

Secondly, the elite 1on1 product ramp up our margin. As we explained before, there is a time lag between cash sales and revenue generation. So in the beginning of this year, we started to sell this elite VIP product. The sales was robust. However, we take for the new students under this program to continue class, and later on and then accumulate and reflect in the P&L, especially the revenue. So in the coming quarters, Q3 and Q4, those are the peak seasons in terms of customers' consumption. We expect the cash will fully reflect in the revenue and then will lead to margin color, which we'll provide better view the next couple of quarters.

Your second question is regarding the sales and marketing percentage of revenue. Indeed, we mentioned a breakdown of this cash sales revenue of 31%. For that number, I just want to elaborate and specialize. Only 14% is spent on marketing dollars percentage of revenue. So that's relatively higher than previous quarter in terms of about 8%, as we explained. That's one, because we have to spend to build the brand to support the Go Premium strategy. Secondly, we need to spend ahead of the peak season, which is Q3 and Q4.

And three, just so you know, this additional 6% incremental growth of marketing dollar only represent about RMB58 million, so it's a pretty modest increase to support our strategic growth. We expect on full year basis, again, as we said before, marketing percentage of -- we use cash rather than revenue, so marketing dollar percentage of cash sales could remain to be 8% to 12% range. That number we mentioned before. So we expect on a full year basis, we'll hit the goal in this range.

Your third question is regarding cash balance, which has dropped some portions, as we explained, to repay the debt we borrowed strategically to prepare for the COVID situations. So we communicated on last quarter's earnings call that we will repay, so this reduction reflects that. So we pay back about RMB419 million for the total debt reduction.

Under the regulatory environment, we will definitely take a very prudent approach in watching our cash liquidity situation. However, I want to elaborate, our cash sales momentum is quite strong, even as of right now, as we disclose to you our cash sales in the last 2 months, March and April, for more than 100% year-over-year. So we continue to see pretty strong robust cash profiles.

As you noticed for Q2, our net operating cash was RMB125 million for a single quarter, compared to a total of RMB241 million for the full year last year. So we are having a pretty robust net operating cash position here. So again, we will wait until the exact written regulatory requirement to be announced. But in the meantime, we're optimistic about our business demand and performance in the future.

Sheng Zhong: Thank you.

Operator: Felix Liu with UBS.

Felix Liu: Glad to see the return to the positive growth on the revenue and the good guidance. My first question is on your margin outlook for the second half. You commented that you expected your margin expansion for the second half. I understand the base was low due to COVID-19. So could you give a little bit more color on the degree of margin expansion? Do we expect to see positive margin in the second half, or the second half still be loss-making?

My second question is on regulation. I understand this round, the government is doing a lot more strict on the enforcement side. So could you share any color on the percentage of teachers that have license, as well as the percentage of learning centers that are properly licensed?

My third question is on our tuition. Again, this ties to the regulation. I think the government is enforcing quite strictly the 3-month rule in terms of tuition prepayment. So may I know how long typically does the tuition prepayment you collect cover? I know your business 1on1 is a little bit special, but I just want to know how much on average the parents have paid for in their course package?

And my last question is on the short-term borrowing. I noticed that the current balance of short-term borrowing on your balance sheet is slightly bigger than your cash balance. So may I know the due date of the short-term borrowings and any refinancing plans?

Greg Zuo: Yes, thank you, Felix. You've got 4 questions here. Let me try to answer one-by-one. So first one is regarding margin expansion. You mentioned that we may have a low base, but as you know, up until Q2 of last year we did have a strong quarter. So for this current fiscal year Q2, we achieved such expansion, quite a good performance, driven by the top line growth. Moving on to second half, we'll continue to see such a top line growth, evidenced by the cash sales which we said provide good visibility for future revenue recognitions. So as we are showing you for the last few months, our cash sales trend continue to trending up, which is a pretty good sign.

You mentioned we may see a loss-making for the second half. Currently, it's hard to comment on the profitability, but we don't think with such a strong top line growth, we will continue to have much losses, operating losses, going forward.

The second question regarding regulations, as I mentioned earlier, it's hard to comment on regulation without knowing the exact written requirements to be announced by the government. But in the meantime, as you guys know, we hold very high standards on our learning environment, quality and services for our students. We are one of the highest standards in the industry, so we are pretty comfortable with the regulatory requirements. We'll continue to follow and comply with government regulatory requirements.

The third question regarding tuition prepayments, yes, we comply with the local government's various requirements when it comes on the enforcement. So we are not concerned at this point any changes on side of practice.

The last question regarding the short-term borrowings, these short-term borrowings are two balances. One is our traditional revolving local banks about borrowings. These banks have been with us for years; they stayed with us throughout the COVID situation. So we have pretty stable and robust relationship with such bank relationships.

As you know in China, typically the local banks only lend on year-over-year basis. As a result, we have to qualify this as a short-term borrowing, rather than long-term. But in reality, the vast majority of these vendors have been working with us over the last few years. So we are pretty comfortable on the liquidity situation, again, with our pretty strong operating cash flow we're generating, so we are comfortable on such position we have.

Felix Liu: Great. Thank you very much, very clear.

Operator: (Operator Instructions). Natalie Wu with Haitong International.

Natalie Wu: This is Yulin on behalf of Natalie Wu. Congratulations on the strong quarter. My first question is about your learning centers expansion plan. Could you help us understand your learning center expansion plan over the next 2 to 3 years? That's number one.

Number two is regarding the competitive landscape. Could management share with us some colors on the competitive landscape, and share with us your thoughts?

Greg Zuo: Thank you for your questions. So the first question regarding learning center expansion plan for the next 2 to 3 years, we will have a consistent learning center expansion, which we rapidly explained on our slides on Page 9. So basically, we'll continue to expand our 1on1 VIP center this year about 10% annualized expansion rates. We said in the earnings material that we've opened already about 20 learning centers, of which some of them have are our flagship VIP learning centers. So we will continue such trends throughout the year.

For next year or two, we probably will continue such an expansion plan, maybe a little bit higher rate when the COVID situation normalizes. But again, let's wait and see the regulatory requirements and how that impacts our plan.

On the second question regarding competitive landscape, yes, as you see, our very strong operational results this quarter, we expect our performance continue to be very strong, which is really a proof that our product and services is at the edge of competitive advantages over our competitors. We're very comfortable that we'll continue to generate such an advance in the future performance. Given the post-pandemic and the new environment of regulations, we feel in the mid-to-long-term, we feel more positive in terms of the opportunity ahead, especially those market consolidation opportunities.

With our strong performance, we expect to continue to consolidate the market shares, especially for the 1on1 personalized learning education market segment. Thank you for the questions.

Unidentified Analyst: Thanks. That's really helpful.

Operator: Thank you. And as there are no more questions at the present time, I would like to return to floor to management for any closing comments.

Ida Yu: Thank you, operator. In closing, on behalf of the entire management team, we would like to thank you again for your participation in today's call. If you have any further enquiries in the future, please feel free to contact us. Thank you.

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