Sunlands Online Education Group [STG]
First Quarter 2018 Earnings Conference Call
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Executives

Yingying Liu, IR Director
Tongbo Liu, CEO
Steven Yipeng Li, CFO
Peng Ou, Founder and Chairman

Analysts

Ronald Keung, Goldman Sachs
Mariana Kou, CLSA
David Li, Lizard Investors

Presentation

Operator: Ladies and gentlemen, thank you for standing by, and welcome to Sunlands' first quarter 2018 earnings conference call. At this time, all participants are in a listen-only mode. After management's prepared remarks, there will be a Q&A session. Today's conference call is being recorded. If you have any objections, you may disconnect at this time.

I would now like to turn the conference over to your host today, Yingying Liu, Sunland's Investor Relations Director. Please go ahead.

Yingying Liu: Hello, everyone, and thank you for joining Sunlands' first quarter 2018 conference call. On the call, our CEO, Tongbo Liu will give you an update on our operational performance this quarter, and update you on our strategic initiatives going forward; and our CFO Steven Yipeng Li will give an overview of our financial performance in Q1 and our guidance for Q2.

Following their prepared remarks, we will move into the Q&A session. Our Founder and Chairman, Peng Ou, and our Chief Strategy Officer, Selena Lu Lu, will also be available to answer your questions.

Before management begins their prepared remarks, I would like to remind you of Sunlands' Safe Harbor statements in connection with today's conference call. Except for the historical information contained herein, the matters discussed in this conference call are forward-looking statements. These statements are based on current plans, estimates and projections and therefore, you should not place undue reliance on them.

Forward-looking statements involve inherent risks and uncertainties. We caution you that a number of important factors could cause actual results to differ materially from those containing any forward-looking statements.

For more information about the potential risks and uncertainties, please refer to the Company's filings with the Securities and Exchange Commission.

With that, I will now turn the call over to our CEO, Tongbo Liu.

Tongbo Liu: Thank you, Yingying. Hello, everyone. Welcome to Sunlands' first earnings conference call as a public company. I'm delighted to say that our performance in the first quarter was very solid. Before our IPO, we were very clear that we see huge potential in the adult education market. And we've always believed that the online education model would drive the consolidation of this huge, fast-growing and fragmented market. We have positioned ourselves better than anyone else to benefit from it. I think our results in the first quarter really back this up.

Our aggressive investments in improving the quality of our courses, in our IT platform and in waking up the potential market, drove record numbers of students to our platform, generating triple-digit growth in several of our key metrics.

Net revenue increased by 161%; net gross billings were up 126%; and new student enrollments more than doubled compared to the first quarter last year.

Besides these financial numbers, I would like to spend some time talking about a few operational numbers, which indicate some of the drivers behind this high growth rate.

First of all, let's look at the back-end of our business, which mainly covers the teaching and learning process. According to iResearch, the national average pass rate of the STE exam-takers who had participated in STE tutoring courses was only 46.5% in 2016. And our student pass rate in Jiangsu Province in 2016 was 71.9%, significantly higher than the national average. In the first half of this year, this number jumped to 79.2%.

This increase was due to our focus on our teaching philosophy, which boils down to a formula: Teaching quality equals teaching time, times teaching efficiency. I can give you two numbers to back this up. The first number is the number of quizzes taken per student, which reached 970 in the first quarter this year, nearly triple the number the first quarter last year. The other number is the student satisfaction rate of our teachers, which reached around 98%.

Secondly, let's discuss the front-end of our business, which mainly consists of sales and marketing activities. Our marketing effectiveness ratio, which is calculated by dividing our marketing spending by our gross billings, remained around 19%, compared to 22% in the first quarter of 2017. Considering the fact that in the education industry, students are more likely to enroll after Chinese New Year, and that we had a late Chinese New Year in 2018; otherwise, this percentage can be even lower.

Last, but not least, our net cash flow from operations reached RMB[232] million in the first quarter this year. And our deferred revenue reached RMB2.6 billion, which both demonstrate that we have significant capital to invest in our future strategy.

Looking forward, to achieve our goal, we will focus on the following three areas. First of all, we will continue to wake up the market, to attract more students who need a bachelor's degree. According to iResearch, in China, there are more than 600 million people between the ages of 18 to 48 who did not have a bachelor's degree as of December 31, 2017. And the limited capacity of the traditional higher education sector offered by the government can only meet the needs of only 20% of people at age 18.

We aim to wake up these people by telling them that through the government-run Self Taught Higher Education Examinations, otherwise known as STE, they can get a bachelor's degree, and they can do it online. More precisely, we will make them aware that even with just a mobile phone, they can not only get a higher degree, but also get a higher salary and improve themselves.

As more people learn about the STE system, the online STE tutoring market is expected to grow to RMB44.7 billion in 2022.

In the second quarter, we will set up new trial classes and upgrade sales and marketing methods to attract more and more customers to the STE program.

Secondly, we will continue to invest in the quality of our courses and content. The massive data collected from our student base allows us to analyze their behaviors, preferences, and learning outcomes, among other things. This in turn enables us to continuously optimize our educational content, teaching quality and the overall student experience.

For example, with the help of our IT platform, our teachers were able to estimate a relatively accurate number of knowledge points in the STE examinations that were held in April, just over a month ago. And this helped our students focus their learning and improve their average pass rate.

In addition, we are also improving the quality and compensation for our teachers.

Lastly, we will keep investing in our IT platform. At the end of last year, we had nearly 600 IT employees, and by the end of this year, this number is expected to double. Our IT team focuses on both the customer side and the operations side of our business to improve our customers' learning experience and the Company's efficiency at the same time.

Our IT platform, Genesis, is fully integrated into every aspect of our business and provides a seamless experience to our students. And the algorithms behind this is one of the main reasons we were able to achieve such a high pass rate.

Sunlands remains the clear number one player in the STE market. We are bigger than the number two to number 10 largest players combined. And we believe that as long as we continuously invest in these three areas, our first-mover advantages and barriers to entry will become stronger.

With that, I'll hand over the call to our CFO Steven to run through our financials.

Steven Yipeng Li: Thanks, Tongbo. Hello, everyone. Thanks for joining us. We are on a very strong financial footing after listing on the New York Stock Exchange. The capital infusion we gained from the IPO, combined with our rapidly growing deferred revenue base, means we have the strong cash position we need to invest in building our platform, improving our content, and continuing to solidify our market-leading position.

Now, I'd like to briefly walk you through some of the key financial results for the first quarter of 2018. All comparisons are year-over-year and all numbers are in RMB.

In the first quarter of 2018, our net revenues increased by 161% to RMB406 million from RMB155 million in the first quarter of 2017. The increase was mainly driven by the growth in gross billings, which was attributable to an increase in new student enrollments.

The significant increase in new student enrollments in the first quarter of 2018 was driven by our continuous investments in improving the quality of our courses and educational content offerings, improving our IT platform, as well as the increase in sales, branding and marketing efforts.

Our cost of revenues increased by 263% from RMB19 million in the first quarter of 2017 to RMB70 million in the first quarter of 2018. The increase was primarily due to the increase in compensation for our faculty members, which mainly included teachers and mentors, as we continued to retain our existing faculty members and attract new faculty members.

Gross profit increased by 146% to RMB336 million, primarily due to the increase in gross billings and net revenues.

Operating expenses were RMB588 million, representing a 149% increase year-over-year. Of these, sales and marketing expenses increased by 137% to RMB499 million, primarily due to an increase in sales and marketing compensation and greater investment in marketing initiatives such as search engine and mobile app advertising.

G&A expenses increased by 267% to RMB78 million, primarily due to hiring more staff to satisfy the requirements of operating as a public company, and also, the foreign exchange losses as a result of the decline in the U.S. dollar in the first quarter.

Our product development expenses increased by 145% to RMB12 million, primarily due to compensation for our content professionals and technology development personnel.

Net loss was RMB245 million, compared with RMB99 million in the first quarter of 2017.

Basic net loss per share was RMB55 in the first quarter of 2018.

Our deferred revenue balance was RMB2.6 billion as of March 31, 2018. The deferred revenue consists of tuition fees that we have received from students, but for which services have not yet been provided to the terms of their service contracts.

Due to our significant increase in gross billings, we generated net cash from operating activities of RMB226 million, compared with RMB140 million for the same quarter of last year.

Our capital expenditures were RMB148 million compared to RMB2 million in the first quarter of 2017. The increase was mainly due to purchases of buildings and leasehold improvements.

Now, turning to our guidance for the second quarter. We currently expect our net revenues in second quarter to be between RMB460 million to RMB480 million, which would represent an increase of 123% to 133% year-over-year.

This outlook is based on current market conditions and reflects our current and preliminary estimates of market and operating conditions and customer demand, which are all subject to change.

And with that, I'd like to open up the call to questions. Operator, please?

Questions and Answers

Operator: We will now begin the question-and-answer session. (Operator Instructions). Ronald Keung, Goldman Sachs.

Ronald Keung: Congratulations on the strong first quarter, not only the billings, but the very strong enrollment numbers. So I have two questions. The first is on your second quarter revenue guidance. Just on the back of the very strong billings in the first quarter, what is your expectation for the growth trends in the second quarter? And we see the second quarter revenue guidance is lower than the first. I just want to hear any thought process behind your guidance, and anything that's related to, for example, the recent press coverage on the student experience.

The second question is could you share with us the ASP outlook, particularly for your STE courses, whether the duration of the courses are changing, or if you could share with us the current split between the diploma bachelor, and whether we're seeing more of the diploma bachelor joint courses that will drive a higher ASP.

(Speaking Chinese).

Steven Yipeng Li: Yes, first of all, thanks for your questions. Regarding your first question, our guidance for the second quarter, yes, [Tongbo] mentioned the [guiding] revenue is a little bit lower than the original guidance. And the reasons for that are merely due to we are paying more attention to the user experience. We want to -- our students who have the better experience.

After the IPO, after we became a public company, we were paid more attention by the media, by the public, and we devised some new methods to make sure our students have the better experience. Number one is how we offer -- Tongbo mentioned earlier, we offer free trial classes to the users, so that [they] can have some experience before they make the decision to become our student.

Second, we offer this zero tolerance strategy. We are starting -- recently, we recorded all of our conversations between our counselors and students to make sure that our students are not being sold as aggressive as before.

And the third strategy is now, we are improving our rebound policy. We are improving our rebound service of our students, so that our students have a shorter time, [weekend] time, for getting back their rebound and also, response to our students regarding their rebound in a more timely manner.

So all those strategies may have an impact on first, our [lost student] revenues and we fully believe that in the long-term, those strategies, those methods, are very key to our success, are very important to improve the [adherence] of our students. So we are very confident that in the long-term, those strategies will be very positive for the Company.

And regarding your second question for the ASP, you may note that our ASPs for Q1 is a little bit lower than the last year. And that's mainly because we are improving the number of students who will pay online; we offer a little bit discount to students who pay online. And we don't expect this will continue in the long-term. With the number of students who pay online get to a certain level, we still are confident that our ASP will improve. As we started, the beginning, we expect our overall ASP for this year will improve 10% to 15% and now, it's still within our expectations.

And regarding the mix in terms of diploma and degree and the STE Program, this is rather the same, very similar to before.

Ronald Keung: Thank you.

Operator: Mariana Kou, CLSA.

Mariana Kou: Again, congratulations on a pretty solid set of results. I think my question is a little bit more on the medium-term development. I understand, we just now talked a little bit about (inaudible) thing and enhance (inaudible). I'm just wondering how did management try to balance between like investing in marketing and also the R&D core content versus (inaudible) the market share is definitely in a good position, especially for an online market.

And it's probably a great time to gain more market share of the industry (inaudible). So just wondering how we are going to balance the two, or we're going to prioritize our market share first, and pretty much come with the balance later; just a bit more color would be great.

And I guess secondly is on ASP. I think we previously talked about our ASP is actually quite low compared to our last [comparative] quarter and the results. So just wondering how we're going to, I guess, longer-term, could close the gap between our products and also the [comparative] offerings in the market. Thank you.

Steven Yipeng Li: Mariana, I'm sorry, you were not very clear. Could you repeat your question? Could you repeat your question in Mandarin again?

Mariana Kou: (Inaudible). (Speaking Chinese).

Tongbo Liu: Okay. Firstly, I will mention that the total marketing is huge, the potential market is huge. As I mentioned, that in China, there are over 600 million people who didn't get a bachelor's degree. And the first group was if you wake more and more people to get a bachelor's degree through STE Program, because most of them, they didn’t know that they can get a bachelor's degree here with STE Program. Second is that they didn’t know that they can do it online. So the first thing is that we're having more and more people; this is the first.

And then secondly, that as you can see, our market effectiveness ratio for the first quarter this year is almost 19%. That is a (inaudible) number than the first quarter last year. So you see that as we are going too fast and as more student enrollments (inaudible) over 100% growth. And at the same time, our market effectiveness ratio goes down. That means our efficiency to acquire new students is better and better. Now, this is (inaudible) I mentioned here.

The third thing is that we believe that we have achieved great growth in next 5 years and in the meantime, we have achieved (inaudible) in 2018, in 2019 and later.

Mariana Kou: (Speaking Chinese).

Steven Yipeng Li: Sorry, Mariana, our Chairman would love to add some insight into your first question.

Mariana Kou: Oh.

Steven Yipeng Li: Just wait a moment, please.

Mariana Kou: Oh, okay.

Peng Ou: (Speaking Chinese).

(Translated). So actually, this question, there are two (inaudible). Number one is we will guarantee our quality is much better than the peers, but only on that condition, we will want more and more market share. That's our priority, but on the condition we can guarantee our quality is much better than the peers.

(Speaking Chinese).

(Translated). As you know, every exam system, we will monitor our pass rate and the student [succession] rate.

(Speaking Chinese).

(Translated). Always, we can guarantee only if we merit. Actually, that number is much better than of the peers. Then our goal, our priority, is to get more market share.

(Speaking Chinese).

(Translated). And the principal too is aware of the changes to actually increase the number of [local distance] taking STE exams.

(Speaking Chinese).

(Translated). These changes are continuous. The (inaudible) for these changes were from that side for our business. We will make it easier for people to join STE Plan.

(Speaking Chinese).

(Translated). For example, as our (inaudible) for the child classes.

(Speaking Chinese).

(Translated). Through this process, we actually were encouraging them to take part in the STE exam.

(Speaking Chinese).

(Translated). And from that side of our business for (inaudible) have already for the STE Program, we will make the quotas and profits more fragmented, and make it easier for them to learn whatever and wherever.

(Speaking Chinese).

(Translated). These two methods, we believe, actually in the long-term will also increase the number of people taking the STE Program as well.

(Speaking Chinese).

(Translated). That's all our Chairman wants to add. Thank you.

Steven Yipeng Li: Mariana, please (inaudible) your second question.

Mariana Kou: Thanks. (Speaking Chinese).

Steven Yipeng Li: Yes, regarding STE, I think by now, the situation has been like before, (inaudible) to admission, doing our actual process. The most important thing right now for the Company is to shift as many students as possible from outside to online. So even though, as you may know, our ASP right now is much lower compared to outside players, even though we have a much higher pass rate and much better student service, but we expect to increase our ASP too fast.

Like I mentioned earlier (inaudible), we still expect our ASP will increase 10% to 15% for this year, but we are fully confident that in the future, once we get more market share from online [players], we will increase our ASP more, because there is a lot of room for us to increase our price.

Mariana Kuo: Thank you.

Operator: (Operator Instructions). David Li, Lizard Investors.

David Li: A couple of questions -- first, regarding the financing income, can you just talk a little bit about how does it work from a regulatory perspective in terms of financing the student tuitions or some of the potential risk? Because you see on the markets where the financing eventually dried up or the problems with financing. We just wanted to [know] about what's the regulatory stand on this? And then I have a follow-up.

Steven Yipeng Li: Okay. Regarding the financing, like we mentioned before, we don’t provide the financing ourselves. We have third-party private providers who provide this service to our students, and this is a very normal education-related installment services. Our interest rate for this financing is only [5.5]% for last year. So it's a very reasonable, very low interest rate; it's nothing like those B2B companies.

And we don’t take any further risk, so which means, one, we will receive the payments from the private providers and the private third-party private providers will collect the installments from the students. So from our perspective, this is a very, again, reasonable education-related installment services. We don’t believe there will be any significant policy risks.

David Li: Do you feel that will be --

Steven Yipeng Li: And --

David Li: Sorry.

Tongbo Liu: And I want to add that the reason we offer the third-party financing is that often, our competitor offers that, because we charge only around RMB6,000 for a degree, for 1 to 2 years degree. That is very low and I think that our customers (inaudible) salary. And often, our competitors, they have to offer that method because they charge double or triple of our ASP. So we think that this is an essential way for them to acquire new students, but it's not essential for us. Thank you.

David Li: But could this financing opportunity -- I understand you don’t take credit risk, but could this financing activity drive bad behaviors from other competitors where -- or the relationship with the banks where it drives them to offer very, very low-quality offering, doing the financing? Is this a thing where it could eventually kind of backfire and then the government will come down and say, hey, we won't allow you to finance anymore because there's just a lot of crappy services out there; and they don’t really provide very high quality?

Steven Yipeng Li: I think first of all, mostly (inaudible) factors for students to consider is the quality of content, if they can pass the final exam. I think that's the most important thing for the students, not the benefit plan or how much they pay. And so that's why we, as Tongbo mentioned, the reason we are providing this third-party financing services to our students is only because all of our competitors are providing the services to their students.

And the second is the policy changes, we actually welcome to the policy change because that will impact all the [off-line] players first because they are heavily relied on this financing services. But for us, like Tongbo mentioned, we only charge RMB6,000 for 2 years for students to get their degree. So we don’t really have to offer this financing services. So if there's the policy change, yes, I think that will impact off-line servers more, much more compared to us, because all of our students actually, they all have jobs; they all have work. So their ability to pay the service is really fine.

David Li: Great. And also on a customer acquisition cost, can you talk a little bit about what, over time, do you guys have any room to drive this down on a per-unit basis? I forgot the number on it, but per new student enrollment? What's it been historically? And over time, how much can you guys drive it down?

Steven Yipeng Li: Do you mean in terms of absolute dollar amounts of the acquisition cost of students?

David Li: Yes, per new students, that's right, over time.

Steven Yipeng Li: Well, first of all, I think the more encouraged we show, we should consider is the acquisition expenses as a percentage of gross billings because if we can get more gross billings per student -- even the acquisition expense per student goes up, I think I saw that this ratio is going down. This should be okay for the Company.

And while in terms of how to improve the operating efficiency of the marketing effectiveness ratio, I think we have mentioned this earlier in Tongbo's comments there, that we are doing a lot of different things. We're using (inaudible) firms; we are improving our teaching quality and content. We are improving the student experience and all those things will improve our revenue earnings, our referral rate in the future. And that will, in turn, improve that ratio, the student acquisition expenses as a percentage of our gross billings.

David Li: Okay. And also competitively, what's -- the Chairman mentioned about your market share is so much higher than just number two, number three player combined. Can you talk a little bit about any of your peers that are just growing as fast as you, that are also gaining market share as well? Any significant players out there emerging?

Steven Yipeng Li: The short answer is no. Right now, we are just so much bigger compared to all the off-line players. We are actually gaining more market share, yes. So to our knowledge, no, we didn’t notice any new beginners there, no.

David Li: Okay, great. Thank you. I'll jump back into queue and maybe ask a question later. Thank you.

Operator: This concludes our question-and-answer session. I would like to turn the conference back over to management for any closing remarks.

Yingying Liu: Once again, thank you, everyone, for joining today’s call. We look forward to speaking to you again soon. Thank you. Good night.