Sunlands Online Education Group [STG]
Second Quarter 2018 Earnings Conference Call
August 24, 2018 7:30 AM

Executives
Yingying Liu, IR Director
Tongbo Liu, CEO
Steven Yipeng Li, CFO

Analysts
Timothy Zhao, Goldman Sachs
Alex Xie, Credit Suisse
Shan Yan, CVC Capital

Presentation

Operator: Ladies and gentlemen, thank you for standing by. And welcome to Sunlands' Second Quarter 2018 Earnings Conference Call. (Operator Instructions). After prepared remarks by the management team, 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' second 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. Our CFO, Steven Li, will give an overview of our financial performance in Q2 and guidance for Q3, 2018. Following their prepared remarks, we will move into the Q&A session.

Before I hand over to management, I would like to remind you of Sunlands' Safe Harbor statements in relation to today's 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 Chief Executive Officer, Tongbo Liu.

Tongbo Liu: Thank you, Yingying. And hello, everyone, and welcome to Sunlands’ Quarter 2, 2018 earnings call. I am pleased to share that in the second quarter, we achieved healthy revenue growth. Our net revenues increased by 134.1%, mainly driven by the growth in new student enrollments as students continued to realize the effectiveness of our mobile and online tutoring offerings.

As we noted last quarter, Sunlands' teaching philosophy is centered around helping students to learn as efficiently as possible. And our highly scalable, one-to-many streaming model allows us to continually invest in developing better technology and content that improves learning efficiency.

Before Steven takes you through the financials, I will share some of the progress we have made in our content and courses, technology and services, as well as in our sales and marketing activities, and how these initiatives have improved outcomes for both our students and the Company.

Over the past year, we have invested significant resources in improving the depth and quality of our content. This can be seen in the number of knowledge points that we teach our students, which have increased from 123,000 at the beginning of the year to more than 275,000 today. By more than doubling knowledge points, we are offering students access to more content that is designed to help them improve their understanding of topics and increase pass rates.

Leveraging cutting-edge technology is another core part of our strategy, and in early 2018, we introduced personalized AI-driven study programs to accelerate the learning process and improve student test outcomes. The AI software, which was developed in-house, uses machine learning and natural language processing technology to analyze student behavior and their understanding of specific courses. Based on this analysis, Sunlands' AI software is able to provide tailor-made learning solutions that are designed to improve study outcomes effectively and efficiently.

These initiatives have contributed to a significant increase in the user stickiness of the Sunlands platform over the past year. In the second quarter of 2018, our students spent an average of 25.6 hours in live-streaming classes, compared to 20.7 hours in the second quarter of 2017. Moreover, students took an average of 1,207 quiz questions in the second quarter of 2018, compared to only 336 in the same period a year ago.

Our efforts have also translated into significant improvements in learning outcomes for our students. For example, in the first half of this year, the number of subjects per Sunlands student passed at average in the Chinese national STE exams was more than double that of subjects per Sunlands students passed at average in the same period last year.

Looking at the front end of our business, during the quarter we improved our sales and marketing approach to enhance the experience of prospective users and improve brand positioning. This includes taking a less assertive approach to sales and promotion, and making it easier for people to learn about our platform. While it will take some time to realize the benefits of these initiatives, we are confident that they will translate into a better experience and more sustainable growth over the long term.

While the STE market offers great potential in China, there is still a need to educate potential users and offer them a chance to see how it works, so they can fully understand the power of our teaching platform. In the second quarter, we introduced free trial classes to not only improve sales and marketing activities, but to further wake up the STE market. These trial classes provide potential students with the opportunity to experience Sunlands' unique offering first-hand, before they commit to using our service.

While the sample size of students for the free trials is relatively small at the moment, the initial results have exceeded our expectations. Participants in free trial classes are significantly more likely to become Sunlands students and enroll in courses with higher price points. Based on data collected from May to July 2018, the average revenue per student who used a free trial was more than 15% higher than those who signed up without a trial class.

The new initiative also increased the efficiency and effectiveness of our sales efforts. The sales conversion rate for free trial participants was more than double the conversion rate for normal sales channels. And on average, it took our sales team half the time to encourage free trial participants to sign up to our courses compared to students who didn't participate in a free trial.

In addition, the refund rate of those that attended free trial classes was less than half our normal refund rate. We will continue to expand the scope of our free trial program to see if these results can be replicated on a larger scale.

Looking ahead, we will continue to invest in our content, teaching quality and technology platform to cement our leading position in China's online post-secondary and professional education market.

As I mentioned in the first quarter, we are focused on doing this in three ways. First, we believe there are huge untapped opportunities in the higher education space, and as the leader, we will continue to drive demand and wake up the market. The limited capacity in the traditional higher education sector means that there is a significant opportunity for Sunlands to expand our reach.

We will continue to offer our free trials to a larger group of potential users to introduce them to our capabilities and allow them to experience first-hand the power of our educational platform. We are also excited that our online platform has the capability to reach even more students across the country even if they only have a mobile phone. By enabling students to gain Bachelor-quality educations, we are also helping to stimulate economic growth and prosperity in regional China.

Second, we will continue to invest in and improve the quality of our courses and content. We are encouraged by the positive response of the launch of our new AI-powered study programs, and will continue to build our analytical tools to provide even more useful and personalized solutions. In the second half of 2018, we will also introduce new course packages and incrementally adjust pricing to better reflect the value we deliver to our students.

And third, we will keep investing in our IT platform, which is the backbone of our business. As we grow and add more solutions to address student needs, we need to make sure we have the IT resources to support. We are on track to double the number of IT employees to around 1,200 by the end of this year. We are also working with a number of leading Chinese tech companies to build our Cloud service to improve the quality of our service, including data collection and analysis.

Sunlands remains the leading player in China's online post-secondary and professional education market. By staying focused, we are confident that our investments in our technology and platform, as well as our focus on the customer experience, will continue to translate into more sustainable growth over the long term.

With that, I will hand over the call to our CFO, Steven, and he will go through the financials.

Steven Yipeng Li: Okay. Thank you, Tongbo. Hello, everyone. Thanks for joining us. We are pleased to have exceeded our revenue projections reflecting the strong demand for online STE tutoring. As mentioned, we have made significant investments in our platform on the front and back ends to secure the long-term growth of the Company.

Let me walk you through some of the key financial results for the second quarter of 2018. All comparisons are year-over-year and all numbers are in RMB.

In Q2, our net revenues increased by 134.1% to RMB481.8 million from RMB205.8 million in the second quarter of 2017. The increase was mainly driven by the growth in new student enrollments. The increase in new student enrollments was driven primarily by our continuous improvement to the quality of our online content offerings, technology platform, as well as an increase in sales, branding and marketing efforts.

Our cost of revenues increased by 230.8% from RMB26.8 million in the second quarter of 2017 to RMB88.5 million in the second 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 continue to retain our existing faculty members and attract new faculty members.

Gross profit increased by 119.6% to RMB393.3 million from RMB179.1 million in the second quarter of 2017.

Operating expenses were RMB688.3 million, representing a 118.8% increase from RMB314.6 million in the second quarter of 2017. Of these, sales and marketing expenses increased by 105.8% to RMB581.7 million from RMB282.6 million in the second quarter of 2017. The increase was mainly due to increase in our sales and marketing compensation and spending on branding and marketing activities, including investments in broadening our search engine and mobile application channels.

General and administrative expenses increased by 258.8% to RMB92.2 million from RMB25.7 million in the second quarter of 2017. The increase was mainly due to the increase in compensation, mainly as a result of hiring more R&D talent to further strengthen our IT infrastructure and R&D capabilities, which is critical to improving the user experience and learning effectiveness.

Product development expenses increased by 126.6% to RMB14.3 million from RMB6.3 million in the second quarter of 2017. The increase was primarily due to the increase in compensation for our course and educational content professionals and technology development-related personnel during the quarter.

Net loss for the second quarter of 2018 was RMB271.8 million compared with RMB132.4

million in the second quarter of 2017.

Basic and diluted net loss per share was RMB39.37 in the second quarter of 2018.

Deferred revenue balance was RMB2,893.5 million. Revenues related to online courses are recognized on a straight-line basis over the service period. Deferred revenue consists of tuition fees that we have received from students, but for which services have not yet been provided pursuant to the terms of those service contracts.

Capital expenditures were RMB97.3 million compared to RMB2.6 million in the second quarter of 2017. The increase was primarily due to the purchase of buildings, leasehold improvements and IT infrastructure equipment needed to support our operations.

Now, turning to our guidance for the third quarter. In the second half of 2018, we will introduce new course packages and incrementally adjust pricing to better reflect the value we deliver to our students. At the same time, we will continue to focus on optimizing our sales and marketing operations to increase effectiveness and improve the profitability of our business.

For the third quarter of 2018, we currently expect net revenues to be between RMB500 million to RMB520 million, representing an increase of 89.4% to 96.9% year-over-year.

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

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). **Timothy Zhao, Goldman Sachs**.

Timothy Zhao: I have two questions. So the first one is that you mentioned that you are going to -- in the second quarter there are some new initiatives on sales and marketing. And I was wondering when do you see that benefit coming into to your financials in December? I understand that from the second quarter, the sales and marketing increased year-on-year and is pretty significant as part of the operating expense.

And the second question is more on the revenue guidance. Can you help me to understand more on what is the basis for this guidance? Because I feel that it is a little bit more conservative from a deferred revenue perspective.

Steven Yipeng Li: Okay. You were -- I didn't hear your question very clear about -- so the first question, let me make sure I understand fully your questions. The first question is related to the sales and marketing expense and the new initiatives the Company has taken during the second quarter, and what -- the impact of those new initiatives to the sales and marketing expense, right?

Timothy Zhao: Yes. And what is the -- when will be the benefit actually kick in into your financials?

Steven Yipeng Li: Okay. Okay. Regarding the first question, actually, as our CEO mentioned, we have already mentioned this during our Q1 earnings call. We are doing those free trial classes in the second quarter; and those free trial classes, based on the current feedback, is very encouraging both in terms of average revenue, average gross billings, I believe, 15% higher compared to the students without trial classes. And the conversion rate is little bit higher and the refound rate is much, much lower. So those are the current results which are very positive.

But however, for the short-term, because right now, we convert a lot of traffic into free trial classes. So in the short term, that may impact our overall commercial rate for the Company. And we expect this trend will continue for several quarters before we can see the positive results on a much larger scale.

Timothy Zhao: Thank you.

Steven Yipeng Li: Regarding your second question, the outlook, the revenue guidance for Q3, basically, we calculate our estimates for Q3 revenue based on the gross billings from previous quarter and our estimated gross billings for Q3. Yes, so that's how we come up with a guidance of RMB500 million to RMB520 million.

Timothy Zhao: Thank you. Can I have a follow-up question on the revenue side, because I noticed that for gross billings per enrollment, the Q2 number is actually declining like year-over-year or quarter. And you mentioned that in Q3, you are planning to launch some new courses and address the pricing, right, on like in which direction the pricing will be addressed?

Steven Yipeng Li: For Q3, we are going to introduce some -- we actually -- we have already introduced some of the new courses. Like for example, our CEO mentioned during his script that we introduced an AI-powered package, and which is much more effective for a student to study it. So that we will charge a higher price. And we will also introduce some course packages with, for example, insurance feature in the package. And those packages with the insurance, we will also charge a higher price to the students. So those new course packages will increase our price points for Q3 and going forward.

Timothy Zhao: Got it. Thank you.

Operator: **Alex Xie, Credit Suisse**.

Alex Xie: So my first question is about your operational changes. After the negative publicity and government reactions you made, what are the key changes that you made and what are the feedbacks from the students and the government?

And my second question is about the gross billings strength. I believe that management has provided revenue guidance. Can we have some more color on the gross billings outlook? Thank you.

Steven Yipeng Li: Okay. Regarding the first question, the negative publicity that occurred in May, that was actually -- there were a couple of reasons why we started to take those new initiatives in order to provide better user experience to our students, like free trial classes, like a live assertive sales approach to students. So as we mentioned earlier, those new initiatives will show effects over time, but in the short term, that may impact our gross billings and conversion rate, but based on the feedback we have gathered so far, the response from the free trial classes are very positive.

And as for the guidance for gross billings, since we only provide the guidance in terms of net revenues, yes, so I don't think, we can have a forecast on the gross billings, sorry.

Alex Xie: May I have one follow-up? That is about what are the government responses to Sunlands' reactions and new initiatives? Are they still checking the malpractices of some sales team, or they are already satisfied with the current regulation?

Steven Yipeng Li: Yes, we have already -- right now, we are in 100% compliance with the government regulations. So all those new initiatives are -- the initiative taken by the Company, so that we can provide better user experience for the students, not because of the government. Now there is no -- any other government regulation violations.

Alex Xie: Thank you. Thank you.

Operator: (Operator Instructions). **Shan Yan, CVC Capital**.

Shan Yan: So I actually heard a lot about the free trial. You mentioned about that, you're quite positive about that. It's an initiative you actually take after the -- like the scandal after May. So I'm quite curious about the conversion rate you mentioned as earlier. This is my first question.

And my second question is actually about the stock price recently, the fluctuations. Do you have any comments on that? Thank you.

Tongbo Liu: Okay. I'll answer the first question. And the conversion rates that students have taken the trial classes is doubled the conversion rates that the students didn't take the trial classes. And we're happy about that; and what I'm happier about that the refund rate of the students take the trial classes is about half the refund rate that of students who didn't take the trial classes. If we do the trial classes continually, that we will wake up more potential students who know the STE and take the examinations. That is one benefit.

And secondly is that this can improve our effectiveness and the efficiency of our sales force. As I mentioned before, the sales team that spent about half the time if a student who has already taken the trial classes, compared to the time spent on who did not take the trial classes.

Steven Yipeng Li: Yes. And this is Steven, the CFO of the Company. Regarding your second question, the recent fluctuations of our share price, I think the share price is depending on lot of different factors; like for example, the macro-economy, the macro-environment of the capital market, or the people's understanding of our business, since we are doing a STE tutoring business, which is brand new to a lot of investors. So I think there are lot of potential factors, but as a company, I don't think we are in a position to comment, on our share price.

Well, there is probably one more thing we can add. There is recent regulations and policy change regarding the education sector in China. Even though that actually minimally impact the free trial business which is -- actually this is very positive to the adult education sector. But some of the investors, they don't have a clear understanding of those new policy change, so that factor may also possibly impact our share price as well. So there are a lot of factors. We really can't comment too much on our share price.

Shan Yan: Sure, sure. Thanks. And I think you missed Credit Suisse second question about gross billings, which I'm also curious about. Well, also I want -- actually, do -- can you give us a figure about the conversion rates you mentioned earlier? You only mentioned that it's like doubled?

Steven Yipeng Li: Yes, well, I actually answered the second question from Credit Suisse. We only give guidance on net revenue; we don't give guidance in terms of gross billings. So well, as for the conversion rate, the normal conversion rate without trial classes can range from 2% to 5%. It depends on different channels and different factors, yes, but overall, that's a kind of rough idea.

Shan Yan: Well, thanks. So which means that for the free trial courses, you actually can have like 4% to 10% conversion rates, right, which means double the normal conversion rate?

Steven Yipeng Li: Yes.

Shan Yan: Okay. Okay. Thanks. That's all of my questions.

Operator: This concludes our question-and-answer session. I would like to turn the conference back over to Yingying Liu 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.

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