Sunlands Online Education Group [STG]
Second Quarter 2018 Earnings Conference Call
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Executives
Yingying Liu, IR Director
Tongbo Liu, CEO
Steven Yipeng Li, CFO

Analysts
Shan Yan, CVC Capital
Alex Xie, Credit Suisse
Christine Cho, Goldman Sachs

Presentation

Operator: Ladies and gentlemen, thank you for standing by. And welcome to Sunlands' Third Quarter 2018 Earnings Conference Call. (Operator Instructions).

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 call over to your host today, Yingying Liu, Sunlands' IR Director. Please go ahead.

Yingying Liu: Hello, everyone, and thank you for joining Sunlands' third 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 Yipeng Li, will give an overview of our financial performance in Q3 and guidance for Q4 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, certain of 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 contained in 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, and welcome to Sunlands quarter 3 2018 earnings call. I'm pleased to share that we made significant progress in strengthening our brand and course offerings during this quarter, as we continued to provide access to affordable, quality education to more students across China.

We grew our net revenue in line with guidance in the third quarter, with net revenues increasing by 95.8% to RMB 517 million. This was mainly due to the strong brand recognition which drove new students to our platform, as well as the expansion of our free trial classes that enable prospective students to experience our advanced online and mobile learning platform firsthand.

Let me now share some of the initiatives we implemented in quarter 3 to enhance our user experience and execute our mission to transform education through technology and innovation.

During this quarter, we continued to diversify our course offerings and improve user stickiness and student engagement on our learning platform. The monthly average users of the Sunlands app increased by over 34% to more than 860,000 users compared to the same period in 2017.

We expanded our value-added offerings, such as our AI-powered personalized study programs, which tailor course content to suit students' individual needs and enable them to learn more efficiently. This helped to improve user stickiness substantially on our platform. In this quarter, the total time spent on live streaming classes improved significantly with students spending an average of 31.5 hours on live streaming classes, an increase of 20% year-on-year. Furthermore, the total number of quizzes taken by all the Sunlands students increased over 900% to nearly 600 million, and students took over 1,600 quizzes on average, which is four times the number of quizzes taken per student for the same period in 2017.

With our value-added offerings and continuous investment in technology and content, we are confident that active student engagement on our platform will continue to increase. This in turn will enable our students to achieve higher pass rates, enhancing Sunlands' industry leadership for this critical metric.

Moving to the front end of our business. In the quarter 2 earnings conference call, we noted that participants in free trial classes were significantly more likely to both become Sunlands students and enroll in courses with higher price points. We also noted that free trial classes also increased the efficiency and effectiveness of our sales efforts. For example, the conversion rate for free trial participants was more than double the conversion rate for other sales channels. And on average it took our sales team half the time to encourage the free trial participants to sign up for our courses compared to students who didn't participate in a free trial.

I'm pleased to report that we continued to see these trends as we expanded free trial classes in the third quarter. We also made further adjustments to the sales process by adding introductory seminars as a preliminary step to improve brand awareness among prospective students.

The introductory seminars are designed to educate potential students about the STE program as well as inform them about the effectiveness and convenience of our industry-leading learning platform. We have found this to be an effective tool to attract potential students, introduce them to Sunlands and start to build trust with our brand.

We now have an independent team of more than 200 people that are dedicated to attracting potential students through these introductory seminars. While our sales representatives previously engaged with potential students on a one-on-one basis, with this new approach, we are leveraging our technology platform to engage potential students through a one-to-many model and encouraging them to join our free trial classes. This is a much more scalable and efficient approach.

And I am pleased to share that the combination of introductory seminars with free trial classes has resulted in higher conversion rates and improved the productivity of our sales efforts. Students who have had the opportunity to experience our platform prior to enrollment also consistently register for courses at higher price points. This reflects the strength of our course offerings and our user-centered education methodology.

Looking ahead, we are confident that our live streaming, one-to-many platform and innovative teaching approach will drive long-term, sustainable growth for Sunlands. With our industry-leading student pass rates and lower price point compared to traditional bricks-and-mortar tutorial institutions, we are well placed to continue to attract students and improve our pricing power in the future.

We will continue to focus on three areas to grow our business. First, we will continue to explore innovative ways to wake up the market and introduce more people to the STE program and Sunlands' educational platform. With hundreds of millions of people between the age of 18 to 48 that do not have a bachelor's degree, we have only just scratched the surface. We are committed to bringing affordable, quality education to as many students as possible and we will continue to expand our introductory seminars and free trial classes to reach more prospective students and provide better access to our platform.

Second, we will keep improving the quality of our courses and educational content that will help our students achieve higher pass rates. We have been very pleased with the increase in stickiness of our platform and improvements in student engagement over the past 12 months. We are confident that our ongoing investments in AI-powered product development will further enhance engagement and lead to better learning outcomes.

Third, we will continue to invest in and develop our IT platform that is the foundation of our business. Our IT infrastructure sits behind every part of our business from sales and marketing, to finance, to learning and student engagement. It is central to our efforts to generate economies of scale and improve the profitability of our business. Together, these initiatives will strengthen Sunlands' position as the leading player in China's online post-secondary and professional education market.

Going forward, we will continue on our mission to transform education through technology and innovation. This will enable us to make quality education available for everyone and significantly improve the lives of Sunlands students across all of China.

Now I will hand over the call to our CFO Steven to run through our financials.

Steven Yipeng Li: Thank you, Tongbo, and hello, everyone. Thanks for joining us.

We are pleased to report that we delivered revenue in line with guidance in the third quarter, reflecting the effectiveness of our initiatives to strengthen brand awareness and attract more students to our platform.

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

In Q3, our net revenues increased by 95.8% to RMB 517 million from RMB 264 million in the third quarter of 2017. The increase was mainly driven by strong growth in new student enrollments.

Our cost of revenues increased by 107.2% from RMB 44.7 million in the third quarter of 2017 to RMB 92.7 million in the third quarter of 2018. The increase was primarily due to the increase in compensation for our faculty members, primarily made up of teachers and mentors, as we continued to retain our existing faculty members and attract new faculty members.

Our gross profit increased by 93.5% to RMB 424.4 million from RMB 219.3 million in the third quarter of 2017.

Our operating expenses were RMB 696.3 million, representing a 45.4% increase from RMB 478.9 million in the third quarter of 2017.

While our sales and marketing expenses declined compared to Q2 of 2018, sales and marketing expenses increased by 58.6% to RMB 542.0 million from RMB 341.7 million in the third quarter of 2017. The increase was mainly due to increases in compensation paid to our sales and marketing personnel, and spending on branding and marketing activities, including investments in broadening our search engine and mobile application channels.

Our general and administrative expenses increased by only 3% to RMB 131.1 million from RMB 127.3 million in the third quarter of 2017. The increase was mainly due to the increase in employee compensation as a result of hiring more talent to further strengthen our general IT infrastructure development capability.

Our product development expenses increased by 134.7% to RMB 23.2 million in the third quarter of 2018. The increase was primarily due to an increase in compensation for our course and educational content professionals and product-related technology personnel during the quarter.

Net loss for the third quarter of 2018 was RMB 226.3 million. For the first time since the listing of our company, our net loss declined substantially, reflecting our progress towards profitability. In addition, our net loss as a percentage of net revenues dropped significantly to 43.8% in the third quarter of 2018 from 98.1% for the same period in 2017.

Basic and diluted net loss per share was RMB 32.68 in the third quarter of 2018.

As of September 30, 2018, we had RMB 1,278.7 million of cash and cash equivalents and RMB

1,088.2 million of short-term investments, compared to RMB 559.5 million of cash and cash equivalents and RMB 353.1 million of short-term investments, as of December 31, 2017.

As of September 30, 2018, we had deferred revenue of over RMB 3,116 million. Revenues related to our online courses are recognized on a straight-line basis over the service period. Deferred revenue consists of tuition fees received from students for which services have not yet been provided to students pursuant to the terms of those service contracts.

Capital expenditures were RMB 10.3 million, compared to RMB 86.7 million in the third quarter of 2017.

Now, turning to guidance for the fourth quarter. For the remainder of 2018, we will continue to invest in the development of quality content, teaching and our technology platform to attract more students to our leading live streaming one-to-many platform. For the fourth quarter of 2018, we currently expect net revenues to be between RMB 540 million to RMB 560 million, which would represent an increase of 56.7% to 62.5% 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.

With that, I would like to open up the call to questions. Operator, please?

Questions and Answers

Operator: (Operator Instructions).

Shan Yuan, CVC Capital.

Shan Yuan: Hi, hello. I actually have two questions for Mr. Liu and Mr. Li. The first is regarding - that I noticed that in China, in most of the marketing materials, that Sunlands has changed its name to, like, Sunlands Technology, right? So I don't know if it's correct, but I'm wondering, does that represent some kind of strategic change of the company, or you wish to be presented more in a sense of a technology company? Well, my second question is that I noticed that there are actually cash -- a cash of around RMB 1.2 billion and short-term investment of RMB 1 billion. So I'm quite curious about what is the main use of short-term investment? Like, do you have less structured short-term products, or can you just specify a little bit? Thank you.

Tongbo Liu: I will -- yes, I'll take the first one and you take the second one?

Steven Yipeng Li: Sure.

Tongbo Liu: Okay. Yes, we did change our name to the technology company, and the reason behind it is that we want to focus on the technology and education as well. And as we mentioned last quarter, that we have over 1,000 IT employees in our company, and we -- and they have focused on the -- every kind of IT infrastructures that help us to engagement and to learning outcomes, every kind of things. And right now they are focusing on the AI-driven IT assistant, which we have a product that is driven by the AI that helps students to save time to pass the examination. And maybe Steven can take the second question.

Steven Yipeng Li: Yes. And I would just like to add a little bit to the first question. Yes, like Tongbo mentioned, we want to add more technology flavor to our company. We'll use our technology platform and AI to help students learn more effectively, but at the end of the day, we are still an education company, so we are doing our best to provide the best content, educational content, to our students. Actually, as you can see, our product development expenses increased by over 130% compared to Q3 of last year. So this change of name in no way means we are shifting our strategy. Both education and technology are the two key driving forces for our success.

Regarding your second question, yes, about our cash and cash equivalents, about around RMB 1 billion are in short-term investments and RMB 1.2 billion in the cash. For those RMB 1 billion short-term investments, those are actually very similar to cash. It's just that for the -- for some of the cash, we are not expecting to use. In the short term, we put them into some of the very low-risk financial products. But in any case, if we want to use those cash, those short-term investments, we can call them back right -- immediately.

Shan Yuan: Yes, sure. Thank you. Well, I mean, it's actually a little bit -- I mean, not worried, but it's just out of curiosity, I mean, with such a huge amount of cash on your balance sheet, have you ever considered maybe to construct or to facilitate merger and acquisition, or some kind of equity investment, maybe, in your peer companies or the kind?

Steven Yipeng Li: Well, we actually mentioned this during our IPO, and also, that's actually part of the use of our IPO proceeds, which is, we are open to any potential merge and acquisition opportunities. And the company is -- we are always actively looking for those kind of opportunities, yes. So we are open to those ideas; it's just that so far, as of now, we haven't done any merge and acquisition yet. But if, in the future, if there is good opportunity for the company to do either investments or even merger and acquisitions, the company is very open.

Shan Yuan: All right, thank you. Thank you so much. That's all my questions.

Steven Yipeng Li: Okay. Thank you.

Operator: Alex Xie, Credit Suisse.

Alex Xie: Hi, management. Thank you for taking my question. So I'll ask several questions. Firstly, I would like to ask about our trends in the student enrollment. It seems that in the last quarter, we had a quarter-over-quarter decrease, about 10%, in the student -- in the number of new student enrollments. I would like to ask about the monthly trend, and particularly, can management share some color on the September and October? And my second question is about our ASP. I noticed that the CEO also mentioned the improvement in ASP in the press release, but I would like to know more about the reasons behind it. Is it more due to the product or offerings mix, or is it due to a price increase in the same course? And what's the plan going forward? And my third question is about our marketing effectiveness ratio. Has it been stabilizing or improving, or what about the -- generally, the traffic acquisition cost and conversion rates? Thank you.

Steven Yipeng Li: Yes, okay. For the first question, regarding the new student enrollment, yes, the new student enrollment for this quarter declined slightly compared to last quarter. And well, the main reason for that, as our CEO, Tongbo, mentioned, we started to do this introduction seminar and free trial classes during the second quarter, and especially we are expanding the scope in the third quarter. For those students who take part in free trial classes and introduction seminars, they are not defined as a new student enrollment if they are not contributing to our current quarter revenue. So that's actually the major reason for the company, why there is a decline in terms of new student enrollment. But we are very confident in the long term. Once those students -- once they take the free seminar, introduction seminar and the free trial classes, they will have a much higher conversion rate and a much lower refund rate. And based on, right now, the limited data we have, we have noticed this trend. So that's the answer for your first question.

And for the second question, in terms of our ASP, our ASP for Q3 increased significantly comparatively as in Q2, and that's mainly due to the product mix. Like Tongbo mentioned, we introduced an AI-powered class and some other value-added services class in Q3, and the students who apply for those classes are actually willing to pay a higher ASP compared to the product without those value-added services. So that's the major reason for the company -- our ASP is much higher compared to last quarter because of the product mix, not because we increased our product price.

And for the last question, regarding the marketing effectiveness ratio, the marketing effectiveness ratio for this quarter is a little bit higher compared to Q2. That's mainly due to, right now, the traffic cost in China is more and more expensive, but the company is favoring all kinds of ways and channels, and we think in a few quarters we will see very positive results. Well, actually, one thing I want to add here is, the entire sales and marketing expenses as a percentage of our net revenue actually declined in Q3 compared to Q2, and although the marketing spending is more expensive, that's because in terms of employee -- sales personnel productivity, it actually improved a lot compared to last quarter. So that's why the total sales and marketing expenses, as a percentage of net revenue, declined compared to last quarter.

Alex Xie: Thank you, thank you, that's very clear.

Operator: (Operator Instructions).

Christine Cho, Goldman Sachs.

Christine Cho: Hi, thank you for the presentation. I have two quick housekeeping questions. The first one is related to your efforts regarding the diversified course offerings. So if you can provide any color in terms of STE versus non-STE, in terms of enrollment or revenues, et cetera, that'd be great. And the second question relates to the G&A expenses. It seems like on a YoY basis it's only up 3%, but on a QoQ it has a sharp increase. Is there any seasonality related to this item that we should consider going forward? Thank you.

Steven Yipeng Li: Yes, okay. For the first question, yes, we actually mentioned during our IPO that our STE accounts for, like, 89% of our total gross billings and non-STE course accounts for around 10%. Now, the non-STE, the contribution is a little bit higher than 10%. It's somewhere between 13% to 14%, as the company is diversifying our course offerings. And the STE contribution is a little bit lower compared to about half year, three quarters ago. But overall the structure is roughly the same.

And regarding the G&A expenses increase compared to Q3 of 2017, one thing I want to remind here is for last quarter -- sorry, for the Q3 of last year, among G&A expenses, there are some one-time ESOP expenses recorded in the Q3 of last year. So I think that is probably part of the reason for the 3% increase compared to last year.

Christine Cho: Sorry, to clarify, I was just wondering why there's such a sharp QoQ increase in the item rather than the YoY. So in the second quarter, it was -- yes.

Steven Yipeng Li: Oh, I see. You mean the comparative Q2 of this year, right?

Christine Cho: Yes, yes, yes. And whether it’s the seasonality issue. Steven Yipeng Li: Okay. Oh, no, that's not a seasonality issue. Okay, it's -- the majority of G&A expenses are actually our R&D personnel. Our R&D expenses will be recorded into cost. Sales, the marketing expense, G&A expense and the product development expense, based on their functions. And most of them will be recorded in G&A expenses. So the increase in Q3 compared to Q2 is mainly due to the company is hiring more R&D talent to build up our platform and everything. So that's the major reason, not because of seasonality.

Christine Cho: Thank you.

Operator: (Operator Instructions).

Showing no further questions, this will conclude our question-and-answer session. At this time, I'd 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, and we look forward to speaking with you again soon. Good day and good night.

Operator: Ladies and gentlemen, the conference has now concluded. We thank you for attending today's presentation. You may now disconnect your lines.