Sunlands Technology Group [STG]
Second Quarter 2019 Earnings Conference Call
Friday, August 23, 2019, 7:30 AM ET

Company Participants:
Yingying Liu; IR Director
Tongbo Liu; Chief Executive Officer
Steven Yipeng Li; Chief Financial Officer

Analyst Participants:
Christine Cho; Goldman Sachs
Timothy Zhao; Goldman Sachs

Presentation

Operator: Ladies and gentlemen, thank you for standing by, and welcome to Sunlands' second quarter 2019 earnings conference call. At this time, all participants are in a listen-only mode. After prepared remarks by the management team, there will be a question-and-answer 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, Sunlands' IR Director. Please go ahead.

Yingying Liu: Hello, everyone, and thank you for joining Sunlands' second quarter 2019 earnings conference call. On the call, our CEO, Tongbo Liu, will provide an update on our operational performance as well as our strategic initiatives. Our CFO, Steven Yipeng Li, will give you an overview of our financial performance and also provide our guidance for the third quarter of 2019. Following their prepared remarks, we will move into the Q&A session.

Before I hand it over to the management, I'd like to remind you of Sunlands' safe harbor statement 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 trends, estimates and projections, and therefore, you should not place undue reliance on them.

Forward-looking statements involve inherent risks and uncertainties. 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. Welcome to Sunlands' second quarter 2019 conference call. As we have outlined in previous quarters, Sunlands is keenly focused on developing and strengthening our brand through several key initiatives. I am pleased to report that these initiatives drove second quarter top-line revenue of RMB552.7 million, which was in line with our guidance and represented a 14.7% increase year-over-year. We also significantly narrowed our net loss margin to 2.3% in the second quarter, versus 56.4% in the same period last year, as we took a firm and disciplined approach to managing costs and expenses.

During the second quarter, we continued to advance our strategic initiatives in an effort to elevate our program offerings and strengthen our brand awareness. Through these unique initiatives, we are building a solid and multi-faceted foundation to reach a high-quality customer base and attract more students to our online platform.

With increased platform accessibility and a diverse approach to student acquisition, we strive to attract new students to our platform. For example, creative marketing techniques such as expansion of our free trial classes enable prospective students to experience our advanced online and mobile learning platform firsthand.

In addition, diversifying our product offerings to include more professional certificate and master's-oriented products, launching and upgrading our mobile app, and building a unique learning community where students, teachers and mentors freely interact with one another, all contributed to the rise in utility and the value of our programs and solutions offer.

Our strategic initiatives also entail a commitment to using technology to further upgrade and distinguish our platform. Through our one-to-many live streaming model, we are equipped to attract and serve a large number of students while, at the same time, add new courses and content with ease and speed. By leveraging integrated AI technology with our online platform, we offer a cutting-edge technological solution and create a user-friendly, personalized experience for students, which facilitates a virtuous circle of recurrent loyal and active users.

Next, let me provide some specifics on several of our key strategic initiatives. First, in addition to our STE programs, as we mentioned on previous earnings calls, we are strengthening our business focus on master's-oriented products. Our master's-oriented products have gained increasing popularity, accounting for 19.4% of our gross billings at the end of quarter two 2019, compared with about 5.1% at the end of quarter two 2018 and 5.5% at the end of 2018.

This strong growth has been driven by the burgeoning master's-oriented education market in China. The number of master's degree applicants in China is estimated to reach 2.9 million by year-end 2019, representing a 21.8% year-over-year growth, the fastest growth rate in the past 10 years. While the number of master's degree applicants has continued to rise, universities and colleges have been tightening their program entrance requirements, and overall program admission rates are down year-over-year.

We see this as a golden opportunity for Sunlands. Capitalizing on this environment and leveraging our expertise in online adult learning management, we are actively working to develop products and solutions that cater specifically market demands of this segment. As an example, since October 2018, in addition to our existing MBA entrance exam tutoring programs, we have added additional categories for our master's programs and have co-developed with universities around the world many online international master's degree programs designed specifically for Chinese adult learners. Overall, we believe Sunlands' online international master's program is the most flexible and sensible solution in the market.

Although our effort to build out our portfolio of master's-oriented products is still in the early stages and will require time to ramp, we are optimistic based on our early tractions. We will continue to enhance our master's-oriented products to take further advantages of the opportunities in this market, as we strive to provide the best fit educational products to Chinese adult learners who are challenged by limited time and ever-increasing pressure from busy lives.

Second, our professional certificate programs are also witnessing robust growth, reaching 8.6% of our gross billings by the end of second quarter 2019, compared with 6.8% at the end of second quarter last year. This growth is being fueled in part by our broader range of course and subject offerings to meet changing market workforce demands for professional certification. With increasingly diversified education products, we are enjoying a more balanced revenue mix.

Third, our mobile app, Sunlands' Speed Edition, a free learning platform with diverse courses launched in January and designed for users with broader interests and intentions for learnings, is proving to be very popular. Designed to meet the busy lifestyle needs of today's adult learner, our app boasts easy, on-the-go accessibility, faster interaction speeds and minimal memory storage requirements.

Speed Edition not only broadens our subject domains and deepens our content offerings, it serves as an excellent tool to build up a self-developed traffic pool of potential students. By the end of the second quarter, we had already recorded nearly 1 million users, up from 250,000 as of the end of the first quarter. This rapid rise in users is a strong witness to the market appeal of our offerings.

Lastly, we continued to upgrade our trial program and customize AI technology to attract prospective students and enable them to see first-hand how our course offerings work. In addition, the excellent results achieved by Sunlands' students in the national examination period are well above national average, which is a very attractive proposition to prospective students.

In the April 2019 examination period, the number of Sunlands students who participated in the exams reached 148,000, increasing 14,000 compared with the October 2018 examination period. Total number of exams participated by Sunlands' students reached 450,000, and the pass rate was as high as 63.1%, further improved from the October 2018 examination period and significantly higher than the national average pass rate for self-study courses.

According to iResearch data, the average pass rate of self-study courses from 2012 to 2016 in China was 43.4% for students who self-studied and 35.6% for student enrolled in private schools. In short, we believe our upgraded trial program and attractive pass rates will lead to increasing average gross billings, conversion rates and sales efficiency over time.

While we are optimistic about the long-term impact our initiatives will have on gross billings and new student enrollment growth, we also see the need to proactively respond to China's slow macroeconomy and the challenges our industry is facing surrounding student acquisition costs. In an effort to manage headwinds, we continue to be strategic and prudent in our cost structure and the timing of our sales and marketing campaigns as well as our operating activities, aiming to achieve the proper balance between investing in new initiatives and mitigating risks. As a result from our disciplined approach, our net loss during the quarter narrowed significantly to RMB12.9 million, decreasing 88.6% from RMB112.9 net loss last quarter.

We are pursuing balanced growth as we execute our five-pronged expansion and retention plan for 2019. With our best-in-class technology, high-quality educational content and one-to-many business model, we are confident in our ability to grow and be the market leader in China's adult online education industry.

With that, I would like to 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. As mentioned, we are pleased to report revenue in line with our guidance for the second quarter. Our gross billings and new student enrollment declined 43.1% and 44.0%, respectively, year-over-year, as we see the need to proactively respond to China's slowing macroeconomy and the challenges our industry is facing surrounding student acquisition costs.

Against this backdrop, we took quick and decisive actions to reduce operating expenses. As Tongbo just mentioned, our second quarter net loss narrowed significantly to RMB12.9 million, compared with a loss of RMB112.9 million in the first quarter of 2019 and RMB271.8 million in the second quarter last year, representing a 95.3% decrease year-over-year. We are confident the steady and focused execution of our five-pronged strategy to expansion and retention will improve average gross billings, conversion rates and sales efficiency over the long term.

Now, let me walk you through some of the key financial results for the second quarter. In the second quarter of 2019, net revenues increased by 14.7% to RMB552.7 million, from RMB481.8 million in the second quarter of 2018. The increase was mainly driven by the growth in the number of students in the second quarter of 2019 compared with the second quarter of 2018 following new student enrollments increase over the past years.

Cost of revenues increased by 8.1% to RMB95.7 million in the second quarter of 2019, from RMB88.5 million in the second quarter of 2018, which was primarily due to an increase in insurance premiums related to online education services with insurance coverage since late in 2018.

Gross profit increased by 16.2% to RMB457 million, from RMB393.3 million in the second quarter of 2018. In the second quarter of 2019, operating expenses were RMB498.7 million, representing a 27.5% decrease from RMB688.3 million in the second quarter of 2018.

Sales and marketing expenses decreased by 33% to RMB389.7 million in the second quarter of 2019, from RMB581.7 million in the second quarter of 2018. The decrease was mainly due to the reduced marketing spending, reflective of disciplined, prudent cost management, and the decrease in the expense of sales and marketing personnel.

General and administrative expenses decreased by 7.9% to RMB84.9 million in the second quarter of 2019, from RMB92.2 million in the second quarter of 2018. The decrease was mainly due to the decrease in office expenses and professional service fees.

Product development expenses increased by 68.1% to RMB24 million in the second quarter of 2019, from RMB14.3 million in the second quarter of 2018. The increase was primarily due to an increase in the number of employees and compensation paid to Sunlands' product and technology development personnel during the quarter.

Net loss for the second quarter of 2019 was RMB12.9 million, compared with RMB271.8 million in the second quarter of 2018. Basic and diluted net loss per share was RMB1.87 in the second quarter of 2019.

As of June 30, 2019, the company had RMB1.5 billion of cash and cash equivalents and RMB269.9 million of short-term investments, compared with RMB1.2 billion of cash and cash equivalents and RMB1.03 billion of short-term investments as of December 31, 2018. As of June 30, 2019, the company had a deferred revenue balance of RMB3.2 billion, compared with RMB3.3 billion as of December 31, 2018.

Capital expenditures were incurred primarily in connection with purchases of buildings and IT infrastructure equipment necessary to support Sunlands' operations. Capital expenditures were RMB2.2 million in the second quarter of 2019, compared with RMB97.3 million in the second quarter of 2018.

And in terms of the key financial results for the first six months of 2019, let me walk you in the details too. In the first six months of 2019, net revenues increased by 25.8% to RMB1.1 billion, from RMB888.2 million in the first six months of 2018.

Cost of revenues increased by 13.8% to RMB181.2 million in the first six months of 2019, from RMB159.2 million in the first six months of 2018.

Gross profit increased by 28.4% to RMB935.8 million, from RMB729 million in the first six months of 2018.

In the first six months of 2019, operating expenses were RMB1.1 billion, representing a 12.9% decrease from RMB1.3 billion in the first six months of 2018. Sales and marketing expenses decreased by 17.9% to RMB887 million in the first six months of 2019, from RMB1.1 billion in the first six months of 2018.

G&A expenses increased by 2% to RMB173.4 million in the first six months of 2019, from RMB169.9 million in the first six months of 2018. Product development expenses increased by 97% to RMB51 million in the first six months of 2019, from RMB25.9 million in the first six months of 2018.

Net loss for the six months of 2019 was RMB125.8 million, compared with RMB517 million in the first six months of 2018. Basic and diluted net loss per share was RMB18.38 in the first six months of 2019, compared with RMB91.06 in the first six months of 2018.

Capital expenditures were incurred primarily in connection with purchases of buildings and IT infrastructure equipment necessary to support Sunlands' operations. Capital expenditures were RMB3.3 million in the first six months of 2019, compared with RMB245 million in the first six months of 2018.

For the third quarter of 2019, Sunlands currently expects net revenues to be between RMB510 million to RMB530 million, which would represent a decrease of 1.4% to an increase of 2.5% year-over-year.

The above outlook is based on the current market conditions and reflects the company management's current and preliminary estimates of market, operating conditions and customer demand, which are all subject to change.

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

Questions and Answers

Operator: (Operator Instructions) Christine Cho, Goldman Sachs.

Christine Cho: Hello. Thank you, Tongbo and Steven. I have three quick questions. So, firstly, I think the guidance came in a bit softer than we were expecting. Could you elaborate on what are some of the macro industry challenges that you're facing and what needs to happen in order for you to regain confidence in stepping up the investments again? And then, secondly, how do you think about balancing growth and profitability in the second half of 2019? And lastly, I think we saw very good effective cost savings come through this quarter. How much room do you think you have for further cost savings?

Steven Yipeng Li: For the first question, regarding the guidance, like we mentioned during the conference call, this outlook is based on the current market conditions, and I think we mentioned there's -- both me and Tongbo mentioned during our conference call that right now the company is more focused on the user experience, and also we are diversifying our product mix. We are relying less and less on STE, and both the master-oriented market and professionals or vocation markets are increasing as well. So I think that for the company, it's kind of in a transition period, so we -- like I said, our guidance is based on the current best estimate by the management.

And the second question is regarding the profitability. Yes, the net loss narrowed very significantly for the second quarter, but, like we mentioned before, the profitability is not the company's number-one focus. We are still -- our primary goal is still to gain as much market share as possible. So in the future, with that in mind, we will still work really hard for this goal. In the meantime, we will control our costs also as much as possible.

I'm sorry, I can't remember the third question. Could you repeat the third question one more time?

Christine Cho: I think it's about the cost saving room going forward. You mentioned -- I think you partly answered that in your second question.

Steven Yipeng Li: Oh, okay. Yes. Well, I can probably add a little bit regarding the -- well, in terms of the cost savings. Yes, for the company, we believe there still is room for us to further save the costs and also the sales -- for example, the sales and marketing expenses. As Tongbo mentioned, right now we are still expanding our free trial classes and some other new initiatives, and we believe once those new initiatives take effect, then we will save more costs regarding the student acquisition costs. Yes, so the simple answer is, yes, we will still have room to further save our costs and expenses.

Operator: (Operator Instructions) Timothy Zhao, Goldman Sachs.

Timothy Zhao: Thanks management to take my question. Just one quick follow-up. I think you made pretty good progress on diversifying the revenue and the gross billings. Can you discuss more about between the master-oriented program and the STE and professional certification? Can you share more color on the ASP and also how much or how long does it take to recognize the revenue?

Steven Yipeng Li: First of all, I want to reemphasize that both the master-oriented education market and professional certification market have huge potential. That's the reason why the company is focusing more on those two subsectors compared to before. In terms of ASP and service period, in the master-oriented education market and professional certification market, unlike STE, their courses sometimes are very different. Some courses are long, some courses pretty short, so it's really hard to give a very exact service period and ASP. But, overall, compared to STE, those courses tend to have a shorter service period and higher -- especially the master-oriented education market has a higher ASP compared to the STE market.

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, Investor Relations Director, for any closing remarks.

Yingying Liu: Once again, thank you, everyone, for joining today's call. We look forward to speaking with you again soon. Good day and good night.

Operator: This concludes the earnings conference call. You may now disconnect your line. Thank you.