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TAL - Q2 2019 TAL Education Group Earnings Call

EVENT DATE/TIME: OCTOBER 25, 2018 / 12:00PM GMT



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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the TAL Education Group Second Fiscal Quarter 2019 Earnings Conference Call. (Operator Instructions) I must advise you that this conference is being recorded today. I would like to hand the conference over to your first speaker, Ms. Echo Yan, IR Director of TAL Education Group. Thank you. Please go ahead.

Echo Yan - TAL Education Group - Head of IR

Thanks, operator. Thank you all for joining us today for TAL Education Group's Second Fiscal Quarter 2019 Earnings Conference Call. The earnings release was distributed earlier today and you may find a copy on the company's IR website or through the newswires. During this call, you will hear from Chief Financial Officer, Mr. Rong Luo. Following the prepared remarks, Mr. Luo will be available to answer your questions.

Before we continue, please note that the discussions today will contain forward-looking statements made under the safe harbor provisions of the U.S. Private Securities Litigation Reform Act of 1995. Forward-looking statements are subject to risks and uncertainties that may cause actual results to differ materially from our current expectations. Potential risks and uncertainties include, but are not limited to, those outlined in public filings with the SEC. For more information about these risks and uncertainties, please refer to our filings with the SEC. Also, our earnings release in this call includes discussions of certain non-GAAP financial measures. Please refer to our earnings release, which contains a reconciliation of the non-GAAP measures to the most directly comparable GAAP measures. I would like now to turn the call over to Mr. Rong Luo.

Rong Luo - TAL Education Group - CFO

Thank you, Echo. Good evening, and good morning to you all. Thank you for joining us today on this earnings call. Our second quarter revenue growth was based on stable demand in the cities we currently cover and a contribution from our online courses. Revenue growth in the second quarter was 53.5% year-over-year in U.S. dollars to USD 699.8 million and 52.5% in RMB terms.

Student enrollment increased by 120.2% year-over-year, mostly driven by the growth in online enrollments as well as Xueersi Peiyou small class.

GAAP income from operations increased by 14 -- 18.4% to USD 80.9 million in the second quarter. Non-GAAP income from operations grew by 23.8% to USD 99 million.

I will now turn the call over to Echo Yan, our IR Director. She will give you an update on our operational progress in the second quarter. After that, I'll update you on our business strategy and execution and discuss our business outlook.

Echo Yan - TAL Education Group - Head of IR

Thanks, Rong. The healthy pace of fiscal second quarter revenue growth was driven by the demand for the various education services in the cities we currently cover. Let me review the business by different revenue streams. Small class, which consists of Xueersi Peiyou small class, Firstleap, Mobby and some other educational programs and the services accounted for 79.6% of total net revenue compared to 80.9% in the second quarter last year.

Xueersi Peiyou small class, which remains our core business, represented 70.5% of total net revenue compared to 72.6% in the same year-ago period. The lower revenue contribution from Xueersi Peiyou was mostly due to the faster growth of online courses.

Net revenue from Xueersi Peiyou small class was up by 49.1% in U.S. dollar terms and 48.1% in RMB terms, while enrollment increased by 72.7% year-over-year. This growth rate reflects the healthy growth in both Peiyou off-line and online class. Currently, we offer Xueersi Peiyou online courses as an additional service, tailored to student's needs in the major cities of our network.

Xueersi Peiyou online offers regular and the short-term courses and other promotion courses. Excluding revenue contribution from Peiyou online in both the second quarter of fiscal 2018 and 2019, the Peiyou off-line small classes revenue increased by 47.3% in U.S. dollar terms and 44.9% in RMB terms, while enrollments increased by 36.6% year-over-year.

In the second fiscal quarter, Peiyou online accounted for 4.7% of total Xueersi Peiyou small class revenue and 29.3% of total Xueersi Peiyou small class enrollments. In the same quarter of fiscal year 2018, revenue and the enrollment from Peiyou online were 2.9% and 10.9%, respectively, of total Xueersi Peiyou small class business.

Xueersi Peiyou small class revenue from top 5 cities: Beijing, Shanghai, Guangzhou, Shenzhen, Nanjing, grew by 42.7% year-over-year in U.S. dollar and accounted for 55.9% of Xueersi Peiyou small class business. Revenue generated from cities other than the top 5 grew by 58% in USD. And the other cities accounted for the remaining 44.1% of the Xueersi Peiyou small class business. This growth momentum is supported by broad market demand across all cities and the incremental ramp-up of enrollment from our earlier classroom expansion.

We make ongoing efforts to diversify our course offerings. Chinese and English courses continue to grow at a solid pace. By the end of August 2018, we have offered Chinese classes in 15 cities and English classes in 24 cities. Furthermore, in our 12 Mobby centers, we have started to offer a wider variety of activities to show the fun part of learning and to cultivate skills such as programming and coding, science, arts and others.

Chinese, English and other subjects of Mobby and Firstleap are still in the early stages of development. These varieties of subjects will gradually contribute more to our overall business. We believe that more diversified courses will help our students perform in school as well as grow into well-rounded individuals. Looking ahead, we will continue to roll out more subjects in more cities and to further widen our course offerings.

Our Zhikang one-on-one business, excluding the overseas consulting business, had a steady second quarter and achieved year-over-year revenue growth of 29.1% in U.S. dollar terms and 28.2% in RMB terms. Including the overseas consulting business, one-on-one revenue grew by 4.1% in U.S. dollar terms. One-on-one, including the overseas consulting business, accounted for 8.2% of total revenue compared to 12.1% in the second quarter of fiscal 2018.

The overseas consulting business was affected by a change in accounting method earlier in the year. On March 1, 2018, the company adopted revenue from contracts with customers, Topic 606, applying the modified retrospective matter to all contracts that were not completed as of March 1, 2018. Results for reporting period beginning March 1, 2018, are presented under Topic 606, while prior period amounts are not adjusted and continue to be reported under the accounting standard set for the prior periods. As a result, both the overseas consulting business revenue recognition as well as year-over-year growth rates have been impacted by the recent adoption of the new accounting method.



Turning to our capacity expansion. As you know, we are pacing our offline capacity growth as we continue to invest in new technology and online business. We added a net 18 learning centers, of which 5 were small class learning centers, 2 new Mobby centers, 4 one-on-one centers and 7 new Firstleap centers. We opened a total of 33 new learning centers among 17 cities and closed down 15 learning centers based on our standard operations and regulatory requirements.

During the quarter, we added 83 Peiyong small class classrooms. Most of small class classrooms were added in Shenzhen, Wuhan, Suzhou, Chongqing, Shenyang and Taiyuan.

By the end of August, we had 648 learning centers in 43 cities across China, of which 460 were Peiyong small class, 12 were Mobby small class, 77 were Firstleap small class and 99 were Zhikang one-on-one.

Looking to Q3, we expect to add 10 to 15 Peiyong small class learning centers. These estimates reflect our current expectations, which may vary due to the change of the demand.

Moving now to our online business. Second quarter revenue from xueersi.com grew by 184.2% in U.S. dollars year-over-year and 183.5% in RMB terms, while the enrollments grew by 223% year-over-year to approximately 2.4 million. Online contributed 11.7% of total revenues and 48.6% of the total enrollments this quarter, compared to 6.3% of total revenue and 33.1% of total enrollments in the same year-ago period, respectively.

The rapid scaling of online courses was mainly driven by sales and marketing online customer acquisition efforts, especially for the summer term promotion as well as the ongoing momentum in demand for online education.

In the second fiscal quarter, promotion in short-term online courses contributed over 1.8 million enrollments. Promotion in the short-term online courses accounted for 77.6% of xueersi.com enrollments and 13.7% of xueersi.com revenue.

In the same quarter of fiscal year 2018, promotion in short-term online courses accounted for 73.2% of xueersi.com enrollments and 12.6% of xueersi.com revenue, respectively.

Finally, other revenues were mostly from online advertising business. It represented 0.6% of total revenue versus 0.7% in the same period of fiscal year 2018.

Let me now go through some other key financial points for the second quarter of fiscal year 2019.

In the quarter, small class ASP decreased by 11.7% in U.S. dollar terms and decreased by 12.3% in RMB terms year-over-year.

Xueersi Peiyong small class ASP decreased by 14.1% in RMB year-over-year. Excluding the impact of Xueersi Peiyong online, the Xueersi Peiyong off-line small class ASP increased by 1 -- 6.1% in RMB terms. Zhikang one-on-one ASP in U.S. dollar terms increased by 15.3% and 14.5% in RMB. Online courses ASP decreased by 12.1% in U.S. dollar terms and 12.3% in RMB in the second quarter, partially due to increase in the amount of low ASP online promotion courses.

Cost of revenues increased by 36 -- sorry, cost of revenue increased by 34.6% to USD 329.6 million from USD 244.9 million in the same quarter one year ago. The increase in cost of revenue was mainly due to an increase in teacher compensation. Non-GAAP cost of revenues, which excluded share-based compensation expenses, increased by 34.5% to USD 329.4 million from USD 244.8 million in the same year-ago period.

In the second fiscal quarter, gross profit was USD 370.2 million, up 75.6% year-over-year from USD 210.8 million in the same year-ago period. Gross margin for the second quarter was 52.9% as compared to 46.3% for the same period of last year.

Sales and marketing expenses increased by 159.4% to USD 151.7 million from USD 58.5 million in the same period of last fiscal year. The increase was primarily a result of more online marketing promotion activities to expand our customer base and brand enhancement as well as a raise in the

compensation to sales and marketing staff to support a greater number of programs and service offerings compared to the same period in the prior year.

Operating income increased by 18.4% to USD 80.9 million. Non-GAAP operating income increased by 23.8% year-over-year to USD 99 million.

Other expense was USD 0.4 million for the second quarter of fiscal year 2019 compared to other income of USD 2 million in the same year-ago period.

Income tax expense was USD 15.5 million in the second quarter of fiscal year 2019 compared to USD 16.2 million same year-ago period.

Basic and diluted net income per ADS was USD 0.14 and USD 0.13, respectively. In the second quarter of fiscal year 2019, non-GAAP basic and the non-GAAP diluted net income per ADS, which excluded share based compensation expenses, were USD 0.17 and USD 0.16, respectively.

From the balance sheet, as of August 31, 2018, we had a total of USD 1,646.5 million in cash, cash equivalents and short-term investments compared to USD 1,498.9 million as of February 28, 2018.

Capital expenditures for the second quarter were USD 42.5 million, representing an increase of USD 4.9 million from USD 37.6 million in the same year-ago period.

Now I will hand the call back to Mr. Luo to briefly update you on our strategy execution and provide a business outlook of the next quarter. Rong, please.

Rong Luo - TAL Education Group - CFO

Thank you, Echo. As you know, our strategy focus in the coming years is online business development and increase market penetration. Currently, we are well on track with repaying investments during this fiscal year in technology, operating models, marketing and other investments needed to be achieved this goal of growing our online business. With our investment in the online content development, technology and marketing we aim to further improve our online product quality, widen our geography presence and make our brand better known.

We continue to pursue a healthy growth in Peiyou small class and other off-line tutoring services and further expand our learning center networks at pace. Over the long term, TAL will gradually transfer its strategy to be a technology-driven tutoring service providers that relies on its smart education solutions, open platform business, competence-oriented programs as well as curriculum based after school tutoring. In serving the public and private schools all over the country, TAL is deeply committed to explore a new model of future education through science and technology. TAL's smart education solution will help to optimize and promote innovation in traditional teaching, implement the national competence strategy requirements and provide essential education resources through AI and other technologies.

TAL's open platform empowers the whole factor, TAL will continuously provide small and medium-sized education institutions in China with its own core education resources, which allows more students to share high-quality tutoring resources through science and technology. TAL believes the competence-oriented educations that are of very critical importance. On one hand, our innovative brands, including Mobby and Firstleap, broaden the parents' options. On the other hand, our curriculum-based courses brands such as Xueersi Peiyou and xueersi.com will offer more and more diversified curriculums and non-curriculum courses, such as programming and coding and et cetera.

Let me now turn to our share repurchase program. On October 24, 2018, TAL Education's Board of Directors has authorized the repurchase of up to USD 100 million of company's common share over the next 12 months. The board will review the share repurchase program from time to time and may authorize adjustment to its terms and size. Any share buyback made under this program will be funded from our cash balance. TAL expects to implement this share repurchase program in a manner consistent with the market conditions and the interests of its shareholders. We will keep you updated on the development regarding the share repurchase program when materially relevant.

Let me now move to the outlook for the next quarter. Based on our current estimates, total net revenue for the [third] (corrected by company after the call) quarter of fiscal year 2019 are expected to be between USD 563.2 million and USD 571.9 million, representing an increase of 30% to 32% on a year-over-year basis. If not taking into consideration of the impact of potential change in exchange rate between RMB and U.S. dollar, the projected year-on-year revenue growth rate in RMB terms is expected to be in the range of 35% to 37% for the third quarter of fiscal year 2019. These estimates reflect our current expectations, which is subject to change. That concludes my prepared remarks. Operator, we are now ready to take questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Natalie Wu from CICC.

Yue Wu - China International Capital Corporation Limited, Research Division - Analyst

I have 2 questions here. First one is regarded with the teacher license. Just wondering how much does the teacher licensing exam taking cause class schedule rearrangement? It affect your next quarter guidance? And would that requirement affect your expansion plan next year? That's the first question.

Second one is about your online investment in margin. So you mentioned that the sale and marketing spiked last quarter, mainly due to your online promotion. So it would be great if you can share with us your spending budget for online next year and how should we see your margin at group level for both this year and fiscal year of 2020.

Rong Luo - TAL Education Group - CFO

Thank you, Natalie. The first question about teacher license. I think because we have put the teacher license as a very high priority in the past few years, so in this industry, the percentage of our teachers who have license is higher than the industry average. And based on the government's policy, this year, most of -- almost all, but most of our teachers who don't have license, they have registered the exams in November, which will happen after 1 or 2 weeks. So we will continue to follow company's -- government's policy to make sure all of our teachers can be compliant. And we don't see a material impact from teaching license in the short term, especially for the next quarter. But if in the longer term, that depending on the execution of the government policy. Based on what I know today, I can't make any judgments. So if we see some material impacts we'll let everybody know as soon as possible. And this is also too early to talk about next year's expansion plan, and we need to balance not only one factor of teacher license but also need to balance the demand of the city and our online progress and some other kind of metrics to decide. Maybe after we finish our whole year budget next quarter we may have it. That would be the right time to talk about that.

The second question about my margins and spending for next year. I think, in the first place, same as what we have told The Street 2 quarters ago, actually, summer is a very important time for us to do online marketing. You probably have seen in Q2, our sales and marketing has been more than \$150 million. Compared to the previous year's, it grew by more than \$100 million. Most of that actually was spending on online marketing. And as a result, the online marketing in Q2, we have -- especially in online-Xueersi online school-we have 2.4 million enrollments. And let me give some split of this 2.4 million enrollments. The 2.4 million enrollments, including almost 0.5 million that is regular class, with normal price and normal terms. Last year, this number is lower than 160,000, so they grow more than 200%. The second part is, we call, RMB 50 promotion course, which means that the students only need to pay RMB 50 then they do enjoy the whole sections. Of these promotions, most of them will focus on the grades in grade 1, grade 4, the first grade junior high and the first grade senior high. And while -- and they focus more on English, followed by math and Chinese. This type of RMB 50 promotion causes enrollment is almost 1 million. And last year, that almost 0.



And the third part that 2.4 million, we still have some normal short term classes and other promotion classes, which is same as what we did in the past. This number, this quarter, is almost 800,000 enrollments, plus/minus. While last year, this number is around 540 million -- sorry, 540,000 enrollments, it grew around 40% plus.

So these numbers, they give us kind of good confidence. We believe the online has penetrated than 2.4 million enrollments, which is very good starting point, especially today, we are facing a kind of a new age, the new students and the new parents, actually, they get used to the online approach much better than before. So, based on these numbers, probably can see moving to the next quarters, maybe the quarters after next quarters, we can see the regular class continue to grow very healthily and there -- the RMB 50 promotion enrollments, they have retained to the next quarter. This retention rate, I have to say, is better than the industry average, but compared to the off-line promotion retention rate, that's lower. And the normal short term classes and other promotion classes, that's well on track. So based on all the things in our mind we probably can see Q3 and maybe Q4 that Xueersi online school, online revenue growth will maintain a similar rate as we can see in Q1 and Q2. Q1 will grow more than 180%, Q2 will grow more than 180%, Q3 and Q4 is almost the same range. And even in Q3, I have to say we -- the most of the spending on marketing happened in Q2, but it doesn't mean we don't spend anything in Q3 and Q4. So compared to Q2, the online market spending is much lower, but we still spend some money in online marketing in Q3 to maintain the online -- Xueersi online school's growth momentum. And again, for the next year spending plan, I have no idea. By the end of today, we still ask you our this year's plan and we will have more ideas when we come into -- by the end of Q3, or maybe in Q4, that's the right time to talk about that. We will definitely keep you guys posted of a progress we have made. Thank you, Natalie.

Yue Wu - China International Capital Corporation Limited, Research Division - Analyst

But with regard to my first question, I thought your next quarter's guidance was partially affected by class schedule change related with the teacher licensing exams taking. So we've looked some kind of the schedule of your classes in major cities, and we find out there's 1 class less in the Autumn quarter, which will be -- we thought will be transferring to the fiscal -- the fourth quarter of fiscal year 2019. So just wondering what kind of impact does this kind of item create?

And with regards to my second question, just a very quick follow-up, do you maintain with the prior guidance of this year's margin? I thought you said that you will see a 1.5% year-on-year down in terms of OP margins this year, right? So just wondering if the message is still being confident?

Rong Luo - TAL Education Group - CFO

The first question about the teacher license, again, I think when we look into this business -- actually, we're looking into the operations in a much longer way, not only one single quarter. Yes, you are right. We can see the teachers entrance -- the teacher's exam, which would happen early November. So the teachers who applied for the exams, they need to go to take exams in that weekend. But this is only the shift from Q3 and Q4. So in our perspective, we don't see to any material impact to my full year numbers. My full year number, for the top line revenue guidance, we made no change in the range of 30% to 50%, close to high end. And the second thing is about the -- and again, remind your second question?

Yue Wu - China International Capital Corporation Limited, Research Division - Analyst

Margin guidance.

Rong Luo - TAL Education Group - CFO

Exactly. Margin guidance, based on what we can see today, we don't have any material changes. We will look very closely into every items of our cost structures. Based on what we see in Q1 and Q2, you probably can quickly figure out, in Q1, we grow our gross margin more than 5 points. Q2 grew more than 6 points. And in Q3, we continue to see we -- the revenue -- the percentage of rental in total revenue actually is also declining compared to last year. So we can continue to see some leverage from the rental and teacher compensation perspective. But at the same time, we

maintain the same level of the IT investment and marketing investment. So based on what we see today, we don't see any material changes here in our this year margin guidance.

Operator

Our next question comes from the Thomas Chong from Crédit Suisse.

Yiu Hung Chong - *Crédit Suisse AG, Research Division - Regional Head of Internet*

I have 2 questions. The first one is about our capacity expansion. How should we think about the regulatory uncertainties, which may affect our capacity expansion in the second half?

And my second question is about the margin outlook. Should we expect -- how should we think about Q3? Or how should we think about our longer term margin, in particular, how should we think about our online margin for the next couple of years?

Rong Luo - *TAL Education Group - CFO*

Thank you, Thomas. The first question about the capacity expansions. Last year, we grew our capacity by around 31%. This year, based on what I can see, also, it impacted by the uncertainty from the policy, I think that expansion will be lower than 30%. And this is we purposely taking initiatives to control the pace of off-line learning centers. And by the same time, we continue to enter new cities through dual-teacher model. Last year, we enter around 12 new cities through dual-teacher models. This year, we enter 1 in Q1 and the other several new cities, we are on track, and so you probably can see that by the end of Q3, we will continue to enter more new cities through dual-teacher models. The number will similar, a plus/minus to the numbers what was last year. So we continue to grow, but we wish to take initiative to be more paced and more controlled.

And secondly, you asked about the margin guidance for the Q3 and the long term and specifically for the online margin guidance. I think, for the margin, what we can see actually is Q3, we need to talk about --- start from top-line perspective. For the top line, you probably can see our guidance now and here, I need to break it down a little bit. For off-line, that is impacted by some of the class shifting from Q3 to Q4. That's only scheduling issues and which it will benefit my Q4 growth, especially in Q3, yes, they have some kind of impact over there. And for online, same as I mentioned just now, we continue to grow 180%, plus or minus, in Q1 and Q2. And Q3 and Q4, almost in the same range.

And for the margin, what we can see for Q3, specifically, because we're moving some revenue from Q3 and Q4, while my fixed cost is almost the same, so yes, there will be a little bit down in my Q3 margin. But that's only timing difference in Q4 where it may recover. So for the full year, we -- based on what I can see today, only information I have today, we don't see any material impact in my full year margin guidance.

And for -- especially for online margin, that's a very good question. We're still remember last year, we're running the online -- in a well-paced way. Last year, our online growth around close to 100%, while the last year's online margin, OP margin is around 9% -- 10% plus/minus. And this year, we decided we wanted to grow market share, our aim to use online solution is to try to provide affordable solution to as many as possible students all over China. So what we care more is the market share, we would care less about profit in the short term. So in the long run, if you ask me what is right range for the online margin, frankly speaking, what I can say is we need to balance the market share and profitability. We don't have any intention to capture so crazy high margin from our online perspective. Online, their key play is to get more market share, serve more students and provide more diversified products, not only today. Today, we own -- our products is around 4,000, 4,500 per year for the regular class. But in the long run, we will diversify the product portfolio, not only with kind of 4,000, maybe 1,200 products. We'll try to use our -- all of our technology to optimize the cost structures to provide solutions and offerings to people as many as possible. So in the long time, we don't pursue a so high margin while we also will maintain in the healthy margin strategy. I don't have any exact numbers to tell you guys today because the time is changing. Right before this year's summer, we'd never think about we will have 2.4 million online enrollments. Last year is only around less than 700,000 enrollments. But today, it's much higher. So we need to keep update -- keep you guys updated when -- with things being more clear. But again, our key play is to get more market share and maintain the margin level in a healthy range, and we will have some margin leverage from off-line to beneficial to our spending in the online. So that's the right strategy where we go, in direction perspective.



Yiu Hung Chong - *Crédit Suisse AG, Research Division - Regional Head of Internet*

May I ask a quick follow-up. It's about -- for this quarter, can you give us some color about the online margin, if there's any color on that?

Rong Luo - *TAL Education Group - CFO*

Do you mean Q2 or Q3?

Yiu Hung Chong - *Crédit Suisse AG, Research Division - Regional Head of Internet*

Q2 and Q3. Is there any color on that?

Rong Luo - *TAL Education Group - CFO*

You are so smart. In Q2, same as what I said in the last quarter earning call, we have some leverage from off-line. You probably can see that gross margin increase more than 6.6%. Operating margin -- actually, it's declined around 3% plus/minus. So this -- the decline of the margins is because of the online. Online, we're spending some online marketing to acquire new customers over there. And looking into Q3 and revenue growth is still quite healthy, and spending for online marketing is much lower than Q2. So we can see for the Q3-- the Xueersi online school will be more healthy than before. But again, today is not the timing to talk about online margin but the time we can talk about whether we can leverage the online products to serve more people. Thank you, Thomas.

Echo Yan - *TAL Education Group - Head of IR*

Hello, operator?

Operator

Our next question comes from Mark Li from Citi.

Mark Li - *Citigroup Inc, Research Division - VP*

I want to ask, I see the deferred revenue grow about 20% year-on-year in this quarter, which is a bit slow. It seems some GAAP with the revenue guidance, around 30%-32%. I want to know what is the key reason for the difference in the revenue and the revenue guidance? And also I want to know about for the regulation of no more than 3 months of getting the fees, any impact to one-on-one business in terms of cash flow or any accounting-wise?

Rong Luo - *TAL Education Group - CFO*

Thank you, Mark. The first question about deferred revenue, which is around 20% year-over-year growth, someone may ask these question right before the call. And I have to remind you guys again, starting from last quarter, we have adopted the new U.S. GAAP policy called the contract of customers Topic 606. We start to adopt this policy on March 1, 2018. This policy represent the estimated amount of tuition class that may be refunded in the near future if the students withdraw from a course of any remaining classes. Right after the adoption of this new accounting policy, starting from last quarter, we need to take certain percentage to estimate a refund rate from the students, and this will deduct from the deferred revenue. They're moving from deferred revenue to other items is only -- but last year, Q1 and Q2, that deferred revenue number is based on old



policy so the number is bigger than what we see this year. If we took everything apple-to-apple and we put all the numbers back to deferred revenue, actually, the deferred revenue growth is very healthy and pretty much on track.

And the second question you asked about our guidance on Q3. I think in the first place, off-line -- off-line, which is pretty much on track, but we shift certain percent -- low single-digit percentage of revenue from Q3 and Q4 because of scheduling issues so, which makes Q3 lose a little bit lower but that will benefit my Q4 to make my Q4 growth better. And online is, as I said in the past, is almost same growth rate. Same range of growth rate as what we see in Q1 and Q2, that's quite healthy. So that's the guidance from my Q3. In Q4, that's a little bit maybe better than Q3, as we all can see. But Q4 is still 2 quarters later, so please stay tuned. I will give more color starting by the end of maybe Q3 earnings call.

And the third question, are you asking about regulation, the 3-months fee policy. I think we as the top players in this industry, we are definitely to comply with the government policies. We're in the process to implement the 3-month policies across our business units. For example, the Xueersi Peiyou small class. Their retention period will start from late October, maybe this week and next week, to early December. So we will change our system to fit in the 3-months policy, with no doubt. We will follow the government policy to do this.

And for the Xueersi one-on-one -- for Zhikang one-on-one, yes we will also adopt this one-on-one policy -- this 3-month policies. But because for the one-on-one, actually, most of their students, actually, coming up from our small class. So we don't foresee a material impact on maybe difference or change to my business due to the change of the 3-month policy. We don't see any material impact on them. And this new policy implementation starting from maybe this quarter, that may impact our deferred revenue next quarter because we have to follow that. And it will also impact the interest income starting from this quarter a little bit. But again, I think the 3-month policy is very good policy because it gives more right back to the parents. The parents can, based on the valuation on the teaching quality of different tutoring schools, and they make their own judgment whether they want to retain or not. We are a company who has actual open classroom policy for a long time. Today, if you come to my Xueersi Peiyou small class actually, the parents can refund any unused class any time. And they don't have any kind of constraints over there. So when we're running -- we are so confident to run into the open classroom policy and free refund policies in the past 15 years. So we are also quite confident to this 3-month policy to give more rights back to the parents. And we believe that's the right way and that's the right policy to help improve the quality of the whole industry.

Operator

Our next question comes from Edwin Chen from UBS.

Edwin Chen - *UBS Investment Bank, Research Division - Head of Hong Kong and China Small & Mid-Cap Research and Research Analyst*

Couple of questions. One, to follow up on capacity, we understand that this year, given the policy uncertainty, capacity expansion slowed down. What about that next year, when do we expect that we can resume the capacity expansion back to 30% target?

And two, is on the margins. Can you update us on the off-line margin in the Q2 and potentially off-line margin outlook for Q3 and Q4?

And three, on your third quarter revenue guidance, 30-something percent and said that online will grow by 180%. So that implied off-line was very low at around 20%, maybe even below 20%? So I was wondering what's the reason behind that other than the teacher's exams impact because it looks like that number was very conservative.

Rong Luo - *TAL Education Group - CFO*

Thank you, The first question about capacity. I think right before I answer you the on capacity expansion in the next -- maybe this year or next year, I think we need to think about that. When we look into this face kind of the new market today, the regulations more and more than before. And we have seen actually the new parents and the new student to start to adopt the online approach much better than before. So we need to think about that. We need to ask one question, so what's the right growth strategy in the coming 2 to 3 years? Is the right strategy for us to do, to continue to grow the off-line, expand off-line learning centers more and more, faster and faster and hire more teachers to deal with that. Or when you think



about that, maybe it's the time, it's the right timing to develop or change or transform our growth drivers to more online. So that's the right question in the ask ourselves.

And we -- and now the first quarter to dealing with the policy issues, which started from almost 2 years ago. So -- but our decision is not only because of the policy, but more because of our opinion or understanding of the new growth driver in the coming 2 years. We strongly believe online, especially the live broadcasting platform with high interactions between the teacher and students, that's the right model to go. And we also believe the dual-teacher models, which can get rid of some constraints in the old model, which is also a way to be more scalable in China's geography.

So when we believe -- strongly believe technology-driven new models, such as dual-teacher model and online live models, that is the right direction to go. So we definitely need to -- we'll kind of understanding with our key focus. So I -- this year, the capacity expansion is definitely lower than 30%, and I have no numbers to let you guys to talk about next year because today is too early to talk about that. But again, we strongly believe if we could leverage like dual-teacher models, especially online, to grow our business, to make our contribution from the online will be more material, that's the right things we want to see. I will give you more colors, for example, this quarter, that's the first quarter, even though we have brought on the promotional enrollments, it's the first quarter Xueersi online school enrollments reached 2.4 million. While Xueersi Peiyou small class enrollments reached 2.4 million, almost the same. But in the Xueersi off-line, that 2.4 million, we'd have to say around 700,000 enrollment actually is Peiyou online. So we see very clear trending our students and our parents start to adopt more and more of our online approach so we need to start it, that's the right direction for us to grow in the coming few years. So I have no timing to tell you, what is maybe which year we will go back to 30%, even in the past 60% capacity growth because we need to go into the right growth drivers and we need to invest in the right direction.

Secondly, about off-line margins, about Q2, Q3 and Q4. And off-line margins continue to get more leverage because we slowed down the expansion, so the rental cost and teacher compensation of the revenue percentage is also lower than previous years. So you'll probably can see in Q1 gross margin 5 points higher; Q2 gross margin 6.6 points higher; Q3 and Q4 we almost can see that same trend, but I can't pair exact numbers based on what I can see today because we don't have enough information to talk about that. But we can see the rental percentage of revenue is definitely lower than what it was last year. So we can continue to get some leverage from off-line, which can make our off-line margins better than last year and which is also make us quite confident to continue the right level of investment on that.

And the Q3 guidance. Q3 guidance today in dollar term is 30% to 32%. In RMB terms, it is 35% or 37%. And I suggest you guys only look into the RMB guidance because the exchange rate is -- that's not -- I cannot control. And in this numbers today, the online in Q2 is only around 11% of my total revenue. So even they grow around 180%, they will not impact that much of my total growth numbers in the next quarter. So next, for the off-line we mentioned that part of the reasons we have scheduling shifting from Q3 and Q4 but for second half, we are still beneficial. So that kind of strategy we will continue to deliver a healthy growth in off-line perspective.

Operator

Our next question comes from Leon Chik from JPMorgan Hong Kong.

Hak Kan Chik - JP Morgan Chase & Co, Research Division - Regional Head of Small and Mid Cap

I just want to ask a question on -- you mentioned you're online and your live is about the same now, both 2.5 million. Do you have any statistics on how many online students would migrate to off-line and vice versa? Or are they totally different markets?

Rong Luo - TAL Education Group - CFO

Thank you, Leon. One correction, it's almost 2.4 million, not 2.5 million. I think we're moving to the student base in off-line and online, today, our online also cover the top tier cities. I think most of our online student still coming from the places we have just opened learning centers. But if we deep dive to the cities, actually, we can see and their online users, I think we can see some kind of synergies between online and off-line. For



example, when we go to one city in Jiangsu, their first -- when we open up a dual-teacher learning center in Jiangsu one city, actually, their first -- most of the students coming to apply, actually, they are coming from Xueersi online school.

And we also see the other direction, some of their students, they started in my off-line, maybe, for example, in the summer or winter, their parents have no time to send their kids to my school every day, so they decided to take online approach. So we see these kind synergies. But the percentage of this kind of students shifting to each other actually is still a small percentage. Most of the students, actually, they like this approach, which is somehow independent from the other approach. And in the long run, our online definitely will go to even more deeper into the lowest lower level cities, and Tier 3 or Tier 4 cities in the long run, that's the place that we will go. So we probably can see this. We continue to see some beneficiaries in the cities where we have off-line centers, which is also can help contribute to the first wave of students in online. In the long run, we believe online is the other market. Online will penetrate much bigger than what we can do in off-line. And online will become a more scalable and popular all over the geographies, and not only in the places we have off-line learning centers. And we believe that's the right direction to go.

And secondly, we also see -- you need to pay attention to the different age of the students. The younger age of students actually, they like the online approach more than the students in the middle school or senior high. And we will continue to develop more services and offerings, which will be maybe more helpful to them to learn through an online approach. In the long run, I cannot figure out what is the exactly scenario will be. Obviously, some of the company, but I believe both online and off-line, they are -- they will contribute each other in the branding perspective and they will help each other and they will help our overall business growth well, while off-line and online will still continue to play in their own markets, most of the students, based on what we can see today, are separate students, but this may change, maybe in 1 or 2 years. So we are continuing to watch what's happening in the market, focus on the students, make sure they have good satisfaction rates, they have good retention rates and we need to develop technology to fit their needs to make sure we can develop the overall business.

Operator

Our next question comes from the line of Lucy Yu from Bank of America.

Lucy Yu - *BofA Merrill Lynch, Research Division - Research Analyst*

It's about your online business. You just mentioned most of the online business -- online students, they are coming from the cities where you have off-line learning centers. Have you figured out a way to attract students from those cities that you have not been penetrated in? Any strategy over there?

Rong Luo - *TAL Education Group - CFO*

Thank you, Lucy. When we're running the online, frankly speaking, we face a lot of big changes in the business. The first one is the online approach. What I can say is I think live broadcasting learning approach is completely different from the other online we have mentioned in the past, which is prerecorded content. So we're facing one change in our business is we changed from prerecorded to live. So when we do these kind of changes, definitely, our first priority is make sure the top 40 cities, which will have presence, we can make more popular. And you know in China, that the Tier 1 cities, the Tier 2 cities, the definitely have much bigger, influence to the other cities compared to the lower level cities. So that's our key priority for this year and we are good to see the progress are on track.

And today, we are also thinking about what is the right approach to target the Tier 3 and Tier 4 cities in the long term. I can't say we figure out the way already. What I can say is we are in the process to make things work in the low tier cities. I can't say what is the ideal model to penetrate Tier 3 and Tier 4 cities. For example, is the newer model, is that the right model to work? I have no idea, so what we can see is we need to pilot, we need to use different ways to do this. For example, in Tier 1, Tier 2 cities, the online marketing is a very efficient way to acquire new students. But when we go to the Tier 3 and Tier 4 cities maybe not. Maybe setting a new learning center over there is a good way to attract new students. So we need to pilot different approach. We have separate teams focused on this. The Tier 3 and Tier 4 cities, that is the place we need to go in strategic perspective. We will continue on this and we will let you guys know if we are making some material progress.

Operator

Ladies and gentlemen, that does conclude our conference for today. Thank you for participating. You may all disconnect.

Rong Luo - *TAL Education Group - CFO*

Thank you.

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