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TAL - Q3 2019 TAL Education Group Earnings Call

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the TAL Education Group Third Fiscal Quarter 2019 Earnings Conference Call. (Operator Instructions) I must advise you that this conference is being recorded today, January 24, 2019.

I would now like to hand the conference over to your first speaker today, Ms. Echo Yan. 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 Third Fiscal Quarter 2019 Earnings Conference Call. The earnings release was distributed earlier today, and you may find a copy on the company IR website or through the newswires. During this call, you will hear from Chief Financial Officer, Mr. Rong Luo; and Linda He, Vice President of Finance. Following their prepared remarks, Mr. Luo and Ms. He 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 the 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 third quarter revenue performance was based on healthy growth of small class business in the cities we currently cover and scaling of our online courses. Revenue growth in the third quarter was 35.3% year-over-year in dollar terms to USD 586 million and 41.4% in RMB terms.

Student enrollments increased by 68.4% year-over-year, mostly driven by the growth in the online enrollments as well as Xueersi Peiyou small class.

GAAP income from operations increased by 59.2% to USD 71 million in the third quarter. Non-GAAP income from operations grew by 63.5% to USD 92.9 million.

I will now turn the call over to Linda He, our Vice President of Finance. She will give you an update on our operational progress in the third quarter. After that, I'll update you on the business strategy execution and discuss our business outlook. Linda, please.

Linda He - TAL Education Group - Vice President of Finance

Thank you. The healthy pace of fiscal third 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.

Let me start with small class as well as other business, which consists of Xueersi Peiyou small class, Firstleap and the Mobby small class and some other educational programs and services. These accounted for 79% of total net revenue compared to 85% in the third quarter last year.

The revenue growth rate was 26% in U.S. dollar terms and 31% in RMB terms.

Xueersi Peiyou small class, which remains our core business, represented 65% of total net revenue compared to 72% in the same year ago period. The lower revenue contribution from Xueersi Peiyou was mostly due to the faster growth of online courses, which accounted for 15% of total revenue in the quarter compared to 8% in the same period last year.

Net revenue from Xueersi Peiyou small class was up by 23% in U.S. dollar terms and 29% in RMB terms, while enrollment increased by 29% year-over-year. This growth rate reflects stable growth in both Peiyou off-line and online class. Currently, we offer Xueersi Peiyou online courses as a complementary service tailored to student needs in major cities of our network.

Xueersi Peiyou online offers regular and short-term courses and other promotion courses. Excluding revenue contribution from Peiyou online in both the third quarters of fiscal year 2018 and 2019, the Peiyou off-line small class revenue increased by 19% in U.S. dollar terms and 25% in RMB terms while enrollments increased by 8% year-over-year.

In addition, excluding Peiyou off-line promotion and short-term courses in this quarter, Peiyou off-line normal priced courses revenue increased by 27% in RMB terms while enrollments increased by 19%.

In the third fiscal quarter, Peiyou online accounted for approximately 5% of total Xueersi Peiyou small class revenue and 34% of total Xueersi Peiyou small class enrollments.

In the same quarter of fiscal year 2018, revenue and enrollments from Peiyou online were 1% and 22%, respectively, of total Xueersi Peiyou small class business.

Xueersi Peiyou small class revenue from top 5 cities, which are Beijing, Shanghai, Guangzhou, Shenzhen and Nanjing, grew by 19% year-over-year in U.S. dollar terms and accounted for 59% of Xueersi Peiyou small class business.

Revenue generated from cities other than the top 5 grew by 30% in U.S. dollar terms and other cities accounted for the remaining 41% of the Xueersi Peiyou small class business.



This growth momentum is supported by broad market demand across all cities and incremental ramp-up of enrollments from our earlier classroom expansion.

We make ongoing efforts to expand our course offerings. Chinese and English courses continue to grow at a solid pace. By the end of November 2018, we have offered Chinese classes in 15 cities and English classes in 24 cities. Furthermore, during the quarter, we opened 4 new Mobby centers to reach a total of 16 Mobby centers. The healthy expansion of Mobby reflects the young parents' keen interest in early childhood activities that combine fun learning with competency building. We expect that these diversified courses will gradually contribute more to our overall business.

Next, I would like to briefly discuss our Zhikang one-on-one business. This business had a steady third quarter and achieved year-over-year revenue growth of 18% in U.S. dollar terms and 24% in RMB terms. Zhikang one-on-one accounted for 6% of total revenue compared to 7% in the third quarter of fiscal year 2018.

Let me update you on our capacity expansion. As you know, we are pacing our off-line capacity growth as we continue to invest in new technology and online business to ensure we are following the new standards and regulations that are currently being implemented. We added a net 18 learning centers, of which 12 were Peiyou small class learning centers, 4 new Mobby centers, 1 Firstleap center and 1 one-on-one center. We closed down 19 learning centers based on our standard operations and regulatory requirements.

During the quarter, we added 225 Peiyou small class classrooms. During the quarter, we entered into 11 new cities, with a new teacher small class learning center in each city, further expanding our geographic coverage. Some learning centers have officially opened, while some others are in the process of decoration and application for relevant approvals. These new cities are Guiyang, Handan, Nanning, Kunming, Yinchuan, Urumchi, Haikou, Harbin, Hohhot, Linyi and Weifang.

By the end of November, we had 666 learning centers in 54 cities across China, of which 472 were Peiyou small class, 16 were Mobby small class, 78 were Firstleap small class and 100 were Zhikang one-on-one.

Looking to Q4, till now, we have rented 13, that is 1-3, small class learning centers, and we expect to add a few more Peiyou small class learning centers. These estimates reflect our current expectation, which is subject to change.

Let's now move to our online business. Third quarter revenue from xueersi.com grew by 157% in U.S. dollar terms year-over-year and 169% in RMB terms, while enrollments grew by 220% year-over-year to over 1 million. Online contributed 15% of total revenues and 40% of total enrollments this quarter compared to 8% of total revenue and 21% of total enrollments in the same year ago period, respectively.

Compared to previous quarter, we ran fewer promotions for online. The enrollments growth in the third quarter came mostly from retention of the summer semester as well as the ongoing dynamic growth in demand for our online live broadcasting.

In the third fiscal quarter, short-term and promotion online courses accounted for 60% of xueersi.com enrollments and 4% of xueersi.com revenue.

In the same quarter of fiscal year 2018, short-term and promotion online courses accounted for 36% of xueersi.com enrollments and 1% of xueersi.com revenue, respectively.

Let me now go through some other key financial points for the third quarter of fiscal year 2019. The breakdown of ASP for the various businesses is as follows. Xueersi Peiyou small class ASP decreased by 1% in RMB terms year-over-year. Excluding the impact from Peiyou online course and promotion and short-term Peiyou off-line courses, Peiyou off-line normal price course ASP increased by a single-digit percentage year-over-year.

Zhikang one-on-one ASP increased by 5% in U.S. dollar terms and 10% in RMB terms year-over-year. Online course ASP decreased by 20% in U.S. dollar terms and 16% in RMB terms year-over-year during this third quarter, partially due to the increase in the amount of low ASP short-term courses.

Cost of revenues increased by 21% to USD 267.6 million from USD 221.1 million in the same quarter 1 year ago. The increase in cost of revenues was mainly due to increase in teacher compensation and rental costs.

Non-GAAP cost of revenues, which excluded share-based compensation expenses, increased by a similar percentage of 21% to USD 267.5 million from USD 221 million in the same year ago period.

Gross profit in the third fiscal quarter was USD 318.4 million, up 50.1% year-over-year from USD 212.2 million in the same year ago period.

Gross margin for the third quarter was 54.3% as compared to 49% for the same period of last year.

Selling and marketing expenses increased by 64.4% to USD 101.6 million from USD 61.8 million in the third quarter of fiscal year 2018. Non-GAAP selling and marketing expenses, which excluded share-based compensation expenses, increased by 62.9% to USD 98.5 million from USD 60.5 million in the third quarter of fiscal year 2018.

The increase of selling and the marketing expenses in the third quarter of fiscal year 2019 was primarily a result of more marketing promotion activities to expand our customer base and brand enhancement as well as a rise in the compensation to sales and marketing staff to support a greater number of programs and the service offerings compared to the same period in the prior year.

Operating income increased by 59.2% to USD 71 million. Non-GAAP operating income increased by 63.5% year-over-year to USD 92.9 million.

Other income was USD 98.7 million for the third quarter of fiscal year 2019 compared to other income of USD 5.4 million in the third quarter of fiscal year 2018.

Other income in the third quarter of fiscal year 2019 was mainly due to the fair value changes of a long-term investment. The fair value changes were transferred from accumulated other comprehensive income to other income as the investment was converted from available-for-sale investment to equity security with readily determinable fair value upon listing in Hong Kong Exchange in November 2018.

Income tax expense was USD 10.4 million in the third quarter of fiscal year 2019 compared to USD 11.4 million same year ago period.

Basic and diluted net income per ADS were USD 0.22 and USD 0.21, respectively, in the third quarter of fiscal year 2019. Non-GAAP basic and non-GAAP diluted net income per ADS, which excluded share-based compensation expenses, were USD 0.26 and USD 0.24, respectively.

From the balance sheet, as of November 30, 2018, we had a total of USD 1,612.3 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 third quarter of fiscal year 2019 were USD 73 million, representing an increase of USD 44.7 million from USD 28.3 million in the third quarter of fiscal year 2018. The increase was mainly due to leasehold improvements and the purchase of land use rights, servers, computers, software systems and other hardware for the company's teaching facilities and mobile network research and development.

As of November 30, 2018, the company's deferred revenue balance was USD 866.3 million compared to USD 1,074.9 million as of November 30, 2017, representing a decrease of 19.4% mainly due to the change of tuition fee collection schedule and the adoption of Revenue from Contracts with Customers, which is Topic 606, beginning March 1, 2018.

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



Rong Luo - TAL Education Group - CFO

Thank you, Linda. These business results reflect that we are well on track with our fiscal year 2019 plans and expectations. As you know, the education industry, including after-school tutoring market is currently in the midst of ongoing education reforms, standardizations and regulations. All these policies are aimed at further improving overall standards and the ecosystem of the entire industry. We are following government directions, and where needed, we will continue to make adjustments into our business operations accordingly.

TAL today is a technology-driven education company in China, and our mission is to advance education through science and technology. When the conditions are right, we are waiting to give support to education institutions in China, especially in lower-tier cities and rural areas with our essential and innovative education products, contents, technologies, services and other teaching resources through our various programs and solutions.

We aim to offer students the knowledge and the skills they need through curriculum courses and extra-curriculum competence building courses. Together with the players in this industry, we will make continuous effort and investments to explore future education models and opportunities.

Turning now to our business outlook. Based on the company's current estimates, total net revenues for the fourth quarter of fiscal year 2019 are expected to be between USD 670.5 million and USD 685.6 million, representing an increase of 33% to 36% on a year-over-year basis. If not taking into consideration of the impact of potential change in exchange rate between RMB and the U.S. dollars, the projected revenue gross rate is expected to be in the range of 40% to 43% for the fourth quarter of fiscal year 2019. These estimates reflect the company's 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) Your first question is from Tallan Zhou from Deutsche Bank.

Tallan Zhou - Deutsche Bank AG, Research Division - Research Analyst

I have 2 questions. First, Rong, can you talk about the guidance of the margin for next quarter and probably, like, growth outlook for online, off-line for next year? And also, second question is, it seems like the margin for this quarter is quite -- is much better than previously mentioned. Any particular reason on that?

Rong Luo - TAL Education Group - CFO

Thank you, Tallan. I will start from Q3 margin questions and then walk through Q4 in the next year. Right before I answer the question, I have to say is, nothing comes easily. All the numbers we can deliver today, actually, require a lot of efforts from the team. And I personally appreciate all the people in our company who have worked very closely and make it happen. Especially in Q3, you probably can go through the numbers. If we are only talking about the non-GAAP OP margin perspective, you probably can see we are making progress in the gross margin same as what we did in the previous 2 quarters. Q3, we increased our gross margin by more than 5 points. The reasons are almost similar to what we've seen in the previous quarters, which is we slowed down our expansion in off-line, which gives some buffer for us to deliver in the margin leverage. And by the end of Q3, we have included -- we have expanded the classroom numbers by around 14% year-over-year compared to last year, which is a little bit slower than our previous years. Part of that is because of the policy reasons, part of that is because we want to control off-line growth pace a little bit. And we also see the other positive reason -- factor to contribute to the Q3 margin, which is better, that is because we scaled down marketing investment. Compared to Q2 -- Q2 -- actually, that's a very important and very prime time to do online promotions because that's summer. Most of the parents will make decisions for their kids which school they will go in the coming few quarters. They make decisions in summer. So Q2, you



probably can see that we run much bigger scale promotions in Q2. But running into Q3, which is fall term, most classes are on track, so we don't have the plan to run that much bigger promotions at that time. All the promotions we are running today, we have a very cautious plan to -- ROI tracking system to make sure every money we put there paying up to their values. So Q3, you probably can see promotion for online is a little bit slower -- smaller than what we see in Q2. These 2 reasons contribute to our OP margins a little better than what we planned in the last quarter. One last point I want to make is, you probably can see that our Q4 net profit -- net margin, which is good, that's because we have capital gain in the other income line. That's because that is the investment we made a few years ago, now they go listed in Hong Kong in November. But all these numbers are noncash, nonoperating items. So as a company, we strongly recommend you guys look into our operations -- operating numbers, including operating margin profits, which is maybe much -- makes more sense to look into the real business compared to the net profit numbers. And guidance for Q4, you're probably -- you're asking specifically about margin guidance in Q4. And let me recollect a little bit. In the previous 3 quarters, we increased our margin in Q1, we declined the margin in Q2, and we recovered a little bit in Q3. So year-to-date in the previous 3 quarters, we are slightly better in margin perspective compared to the same year ago period for the previous 3 quarters, around 1%. And so running to Q4, we are also looking into our different growth drivers. For off-line, we continue to make cautious expansions, and we continue to see some -- much leverage is coming from off-line, which is similar to what we can see in the previous quarters. But for online, we believe winter maybe is also the other window for us to run some promotions. So we are -- some of you guys probably have seen that in the online marketing channels with that too running some promotions in the online space, which will cost some money. The scale of the online marketing is lower than Q2 level, but higher than Q3 level. So looking to Q4, I think we both have some pros and cons, good news and challenges over there. In general, we don't give the detailed guidance about Q4 margins, but we want to let you guys know is actually Q4 is also a good quarter for us. We want to make sure we can ask you our online marketing strategy to deliver our growth results. And specific question about the revenue outlook for next year, what I can say is, actually, if you guys have followed us for a long time, you probably can feel that last year 2018, that's a very important year because in that year, we have seen a lot of new dynamics in this market, including the policy and regulation uncertainty, including the new technology development with probably some new online companies is coming up. They are also including some of the new market dynamics. So all of these factors make us more cautious now when giving -- maybe when giving long-term guidance. So we suggest we only give you guidance quarter-over-quarter because we have high visibility right over there. And looking to the whole year, I think we need to evaluate all of our dynamics and uncertainties right over there. When we finish our all year -- full year budgeting, we'll probably have more information to share at that time. Thank you, Tallan.

Operator

Your next question is from Natalie Wu from CICC.

Yuzhong Gao - CICC - Analyst

This is Yuzhong on behalf of Natalie. We have 2 questions. The first one is on your deferred revenue. I guess, how much of your deferred revenue has been impacted by the new tuition collection policy? And may we know which cities have adopted such new policy, if not all of them? And second question is on your online promotion plans for summer of 2019, whether -- if you plan to do usual RMB 50 courses just like last summer or some free trial courses just like this winter? And how much marketing budget have you prepared for that? And how should we look at the growth outlook of Xueersi online into fiscal year '20?

Rong Luo - TAL Education Group - CFO

Let me clarify. The second question is about my marketing plan for next year summer, right?

Yuzhong Gao - CICC - Analyst

The -- yes, the online promotion plan for summer of 2019.



Rong Luo - TAL Education Group - CFO

Yes, okay. So I will give first question to Ms. Linda He, who is finance Vice President in these areas and quite familiar with all accountings about deferred revenue. And I will answer your second question.

Linda He - TAL Education Group - Vice President of Finance

Sure. This is Linda. Thanks for the question. All the government policies and regulations are aiming to improve the whole industry's level of service and standards and also the overall environment. And our players in the industry should follow the relevant standards and requirements. And for your question, yes, according to the regulations issued last year in August, parents cannot be billed for more than 3 months. It does have impact on our deferred revenue and cash flow. Since the policy has been issued, we have followed the government's requirement to make necessary adjustment of our tuition fee charging policies if needed. This particular policy actually gives a right of choice back to the parents, which we believe is a right and good practice to protect the parents' rights and interest and, as I just mentioned, helps to improve the overall industry environment. And as you know, we have always had an open tuition fee refund policy ever since the company was established. For example, the Peiyou small class business, refund policy is that the parents and students have the right to refund the tuition fee for courses they have not attended before the end of the courses. They are now satisfied. And in addition, another relevant factor is the new accounting standard, and that has been adopted since the first quarter of fiscal year 2019, which requires the company to estimate the refund rate and to reclassify part of the deferred revenue to accrued expenses and other current liabilities. And in terms of the pro forma, we charge tuition fee based on the spring, summer, autumn and winter semesters. Among the 4 semesters, summer and winter semesters' course period is normally less than 3 months, whereas spring and autumn semesters' course period is normally longer than 3 months. So if we took consideration of both the refund reclassification and the schedule change in tuition fee collection and made an apple-to-apple comparison, the deferred revenue in the end of third quarter of fiscal year 2019 would increase by more than 30% year-over-year. I hope this answers your question. Thank you.

Rong Luo - TAL Education Group - CFO

Yes. And the second question about marketing, online marketing, including the format of marketing, including amount of marketing for next year budget. I think that's a very good question. This year, we run the marketing promotions. We use RMB 50 classes and some more classes to do that, and we're investing in online marketing channel, including WeChat channels, Baidu channels, Toutiao channels and other channels to attract new students. I think this kind of marketing promotion-driven growth works at least for Q2 and the coming maybe 1 or 2 quarters, but we have to see that if we don't change the way of doing marketing, we don't change the way to attract students in. If we continue to do the same marketing in the same way, actually, the marginal cost for 1 new users will be higher and higher. So one question is getting back to us: what's the right decision for us to make next year, how to attract new customers, how to maintain high growth? The way we are running today, some of the good learnings, we probably will continue to execute. For example, the 50 RMB class -- pilot class. But some of the ways maybe we will not implement again. For example, if we went into the lower-tier cities, maybe we need to be more innovative, not only in online, but also need to consider some other to leverage our off-line presence -- off-line advantages. Coming to today, we can't say we find a good model or perfect model how to penetrate the low-tier cities and how to try to optimize the return of marketing in a more efficient way. All we need to do is and what we can do is list all the possibilities and all the way of channels and then we do pilots. We use our ROI tracking system to make sure every investment -- every money we make can bring some value. And so if you ask me the format of the kind of pilot classes will change or not, my answer is yes. Some of them will be the same, but we need to continue to be innovative to think about the new ways to do the classes. And specifically about amount, how much money we want to spend next summer. I think today, it's still too early to talk about that because we need to figure out or finalize the way of marketing, where we're running for online in the coming few quarters. We may change the strategy. We may change the way of operation. So today, it's too early to talk about the detail amounts for that. But what we can say is, we continue to believe online is one of very good way to be scalable for the company, and we'll leverage the online, not only cover more students, but also try to offer affordable solutions to support students as many as possible. We don't ask for crazy margins for online. What we want is, we can leverage these kind of offerings to cover more students and help more. So we will -- we, as a company, will also be cautious about that. We will be very, very serious about how much money we spend and which will not bring too much pressure to our margins. So we'll probably let you guys know when we have more information. Please stay tuned for that. Thank you.



Operator

Your next question is from Thomas Chong from Crédit Suisse.

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

I have 2 questions. The first question is on regulations. Can management give us some update about the off-line and online regulations, update if there's any, as well as the teachers passing rate of exams. If there's any expectation or color on that would be great. Second is about online investment. Can management give us some color about how we should think about the online investment as we go into FY '20? And should we expect narrowing losses for next year?

Rong Luo - *TAL Education Group - CFO*

Thank you, Thomas. About regulations, I think starting from the July earning call, which is the first time we head off to The Street much earlier than the other companies to notice the uncertainty and the risk coming from policy and regulations. And coming into today, it's almost 6 months now. So we probably see a lot of documents and policies issued from the government, which has greatly improved the service standard of the whole industry. And we say, as we always said before, as the leading player in this industry, we fully agree with all the policies and try to execute the policies in our operations as much as we can. You probably can see there, one of the good example, this quarter, we closed around 19 learning centers. Some of that is because the standard operation schedule, for example, the lease is due, so we moved to the other place, but some of that is because we want to follow the government regulations to make sure our centers can be complied. So we closed some unqualified centers and rent the other ones and to move the students into -- we try our best to be compliant with all the government kind of policies. And we believe all of these policies, at the end, their purpose is not to try to kill the industry, their purpose is try to protect the rights of parents and give more right of choices back to the parents, which also can protect the whole industry and will be beneficial to all the compliant companies in the long run. And besides what you have seen, off-line regulation policies, and we have disclosed and make you very open to all of you guys in the past earning calls. Based on today's opinion, we don't have any more information to share. If we have some new policies, we will see -- we definitely will disclose and communicate with you guys in the first time. Specifically, for online environments, I think -- which is the same, I think in the last few months policy the government has made, general principle is they need to regulate the online same as what they did in off-line. From our company's standpoint, we welcome all the regulations, policies in online environments. If any new policy was out, we definitely will become the first companies who will go and implement all the policies in place. We have a very strong IT and technical team now, more than 3,000 people, in our company today. So with that team, we will make our system adaptive and flexible enough to adapt all of the new changes, which is possible to come because of policies. Again, I strongly recommend all of you guys can watch the government's policies if there are more new things to come. And we, as a company, will disclose and communicate that if we have more information about that.

And about your question about teacher exam passing rate, what I can say is this year's teacher exam actually will have many more applicants than before. And our teachers, most of them graduated from top universities. So based on the preliminary results, we can see our performance is a little bit better than the whole industry average. But that's only in the paper-based exam results. They still need to go through the interviews. And no matter how many people they can pass all of these exams, we will continue to encourage our teachers, who don't have license, to go and apply for the new teacher exams and try to get teacher license by the end of the exams. We continue to encourage all of them to do so. And your question about online investment, I think you're asking maybe our online business next year is profitable or not. I think surely to say that, on one side, we have seen some good news -- good signals. We have seen parents are getting more and more familiar with online approach, and they are getting used to use online to teach their students, especially the primary school students. And we also were happy to see after a few quarters operations, we have a lot of lessons learned, and we try to continue to innovate our classes and products. But on the other side, we also faced other pressures. For example, the way we're doing online marketing today may be not as efficient as today next year. And we need to think about some of the new way of marketing to make it happen, and we need to find some new growth drivers if possible. So I can't estimate today in today's standpoint to say, hey, we will spend less money or more money. What we can say is, we will continue to be very cautious about all the investments we make, and we will continue to be very confident. We will continue to grow our online business in a much more scalable way. So we will keep you guys posted about our progress in online quarter-over-quarters. And definitely, we believe that is the right direction to go, which will give us much big opportunities in the long run. Thank you, Thomas,



Operator

Your next question is from Mark Li from Citi.

Mark Li - Citigroup Inc, Research Division - VP

My question is, for the last quarter's non-GAAP OP margin, I think, you actually beat management's guidance by, like, about more than 300 basis points. May I know at that time compared to right now, what is the difference that explain the better margins that we previously estimated? What would you rank the factors?

Rong Luo - TAL Education Group - CFO

Thank you, Mark. The first one is Xueersi Peiyou's small class operating efficiencies and their pace of expansions is better than what we expected. We also started seeing their capacity utilization rate is also a little bit better than before, because we slowed down the new capacity. So definitely, we probably can see some maybe bigger leverages than what we expected in the early time of the quarter. Secondly, I think, is the thing what I mentioned just now is because their promotion level of the Xueersi online is smaller than what we expected. The online investment, definitely, we need to evaluate from -- day-by-day because we need to evaluate their ROIs and make sure their tracking is well on track. If we see some of the return is not going quite well, we will reduce the investments and reduce the total amount. So that is a dynamic process is hard to predict much earlier before the end of quarter. So in Q3, we probably see 2 drivers which contributed to much better -- a little bit better margin status. But again, I think, in the long run, the story was the same. For online -- for off-line this year, we continue to improving the operating efficiency to make the budget a little bit better than last year, while the online, we continue to seek for market share. And we will balance their investment over there to make sure we can maintain a high growth and try to save our money as much as possible to make sure that all the investments we make have some -- have better ROIs than before. So that's kind of the mixed result of these 2 drivers.

Mark Li - Citigroup Inc, Research Division - VP

I just want to make sure so you didn't mention the regulation maybe related factor. So do you think, actually, the regulation development is not meaningful to the margin better than expected for the last quarter?

Rong Luo - TAL Education Group - CFO

I don't think so. Because of the policy and regulations, we slowed down the capacity expansion rates. You probably can see that already. Last year, we grew our capacity by more than 31%. The year before last year was over 50%. Two years before last year, it actually is around 80%. The numbers, today -- by the info today, that's only 14%, 1-4. So I think, in the short term, if we want to comply with the government policy and regulation, so we change the way of expansions definitely. This has been reflected in our numbers now. And -- but in the long run, we still believe with all the regulations in place, which aim to protect the parents' rights and which aim to improve the service level or service quality of the whole industry, we -- the compliant companies in the long run will be beneficial. And about the -- and at the same time, also one point I want to make is, based on our own numbers, we don't see significant or meaningful number of students who moved from the other small companies to us. Most of our revenue still is contributed by our organic growth. We have Xueersi Peiyou small business. We have Xueersi online. We have Xueersi online school. And we have all of our offerings ready. We continue to improve our teaching quality and service level and to make sure we could satisfy the parents and students. We strongly believe most growth -- we need to drive most growth through our organic drivers, not from the other company. And that is what we see today. And looking forward, we have -- we don't have any kind of expectations about whether policies will be worse or will be better. What we can do is, whenever we have new policy coming up, we will disclose and communicate to you guys as soon as we can. We -- as a company, we need to make sure we build ourselves stronger, which make us -- can be more flexible when we face the policies and challenges over there. Sometimes, the people will forget something very easily. The story happened 2 quarters ago and some people will forget after 1 or 2 quarters. But we, as a company, we're running the business in this market, we cannot forget all of that. We need to follow the new rule, new policies within



this environment, and we need to change our growth drivers to be more adaptive to the new challenges. So that's the only way for us to continue to grow sustainably in the long run. Thank you, Mark.

Operator

Your next question is from John Wang from Macquarie.

John Wang - Macquarie - Analyst

My question is, can you share some colors on current utilization rates of the existing learning centers? And how much further can we go? And also, do you need to expand aggressively next fiscal year in order to meet the demand? Can we share some guidance on the next fiscal year capacity ramp-up speed?

Rong Luo - TAL Education Group - CFO

Thank you so much for your questions. Last quarter, our utilization rate has been slightly increased, around 1%. And because in our classes, the seat fulfillment rate is always high, and the retention is also very healthy. So we believe maybe in the long run we still have maybe low single digit percentage of potential to increase this metrics, but that's it, don't be too much -- don't be too optimistic about that because we are already quite high. And secondly, about expansions, this year, you probably can see, in Q3, we entered 11 new cities through dual teacher models. So let me clarify, since around 1 or 2 -- some 18 months ago, we had decided we don't expand our off-line model to new cities. Most of the places we enter actually through dual teacher models. Last year, we entered around 12 cities, and now this year, by the end of today, 11 cities. And at the same time, we also see huge -- sorry, we also see very healthy growth from the online segment perspective with triple digit. So we need to -- as a company, we need to balance. We have the high growth drivers in online. We have the new model called dual teacher models, and we have the off-line, which is our traditional models. We need to balance all of them. If we can drive the growth through online, which is more kind of -- which is better then we can drive the growth simply from off-line. So looking forward, we will continue to balance our 3 drivers and making sure we can leverage their advantages of different drivers to try to penetrate more cities in a more healthy way. But I can't figure out today to say whether we will expand faster or slower of the next year off-line network. So we probably will continue to give you guys numbers quarter-over-quarter. And we will continue to follow all of government policies and regulations to make sure the new learning centers we enter is compliant with the government requirements. So please stay tuned. We will give you guys numbers quarter-over-quarter. Thank you.

Operator

Your next question is from Lucy Yu from Bank of America Merrill Lynch.

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

I got 2 questions regarding online in the third quarter. Can you talk about online margin impact in the third quarter in terms of non-GAAP operating profit? Secondly, can you give us some color on the online retention rate going from fall semester to winter semester?

Rong Luo - TAL Education Group - CFO

Thank you, Lucy. Online marketing margin impact in Q2, same as what I said just now, actually, better non-GAAP OP margins, which is contributed by our leverage from gross margin, which is because we slowed down a little bit in off-line network, which gives us more buffer in the margin perspective -- as well as the online marketing. I think these 2 drivers contribute to a little bit better in non-GAAP OP perspective. Same as before, because of the competitive reasons, we don't disclose detailed numbers about online marketing, but what we can say is, the scale of online marketing in Q3 is significant lower than Q2. And the retention rate for online, here, I think what we mentioned is retention rate of the regular class.



The regular class retention in online compared to the off-line is slightly lower and since in Q2 we were running large scale of promotions. So in Q3 and Q4, especially in Q3, it's very important for us to focus on the product and services we deliver to make sure we can improve retention rates as much as we can. We still have a lot of efforts we can pay, and we should have a lot of kind of spaces we can improve in the long run. So we wish maybe in the future quarters after efforts of our team. The retention rates in online can be higher than today. Thank you, Lucy.

Operator

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

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