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DL - Q1 2019 China Distance Education Holdings Ltd Earnings Call

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CORPORATE PARTICIPANTS

Mark A. Marostica *China Distance Education Holdings Limited - Co-CFO*

Zhengdong Zhu *China Distance Education Holdings Limited - Co-Founder, Chairman of the Board of Directors & CEO*

PRESENTATION

Mark A. Marostica - *China Distance Education Holdings Limited - Co-CFO*

Good evening, and thank you for joining us for the China Distance Education Holdings Limited First Quarter Fiscal Year 2019 Earnings Conference Call. On today's call are Mr. Zhengdong Zhu, Chairman and CEO; and Mr. Mark Marostica, co-CFO. During management's prepared remarks, all participants will be in a listen-only mode. Following management's prepared remarks, we will open the call for questions. Before we start, we remind listeners that this conference call contains forward-looking statements. These statements are made under the Safe Harbor provisions of the U.S. Private securities litigation Reform Act of 1995. The outlook for the second quarter and full fiscal year 2019, oral statements from management on this call as well as the company's strategic and operational plans, in particular, the anticipated benefits of strategic growth initiatives, including the promotion of the company's lifelong learning ecosystem as well as cost control and year-over-year improvement in the operating margins among other things may contain forward-looking statements. Forward-looking statements involve inherent risks and uncertainties. A number of factors could cause actual results to differ materially from those contained in any forward-looking statement. Further information regarding this and other risks is included in the company's annual report on Form 20-F and in other documents of the company, as filed with the Securities and Exchange Commission. The company does not undertake any obligation to update any forward-looking statements, except as required under applicable law.

As a reminder, this conference call is being recorded. In addition, the presentation we will be referring to during the course of the call can be downloaded from the company's Investor Relations website. Further, a webcast of this conference call will also be available on the company's IR website at ir.cdeledu.com.

I will now turn the call over to Mr. Zhu. Mr. Zhu. Please, go ahead.

Zhengdong Zhu - *China Distance Education Holdings Limited - Co-Founder, Chairman of the Board of Directors & CEO*

(foreign language)

Mark A. Marostica - *China Distance Education Holdings Limited - Co-CFO*

Thank you everyone for joining our First Quarter Fiscal Year 2019 Earnings Conference Call. Our operating results were distributed earlier via internet newswire services and are also posted on our website, where a slide presentation is available as well.

Zhengdong Zhu - *China Distance Education Holdings Limited - Co-Founder, Chairman of the Board of Directors & CEO*

(foreign language)

Mark A. Marostica - *China Distance Education Holdings Limited - Co-CFO*

If you will now refer the presentation, I will begin on Slide 4 with an overview of our financial results.



Zhengdong Zhu - *China Distance Education Holdings Limited - Co-Founder, Chairman of the Board of Directors & CEO*

(foreign language)

Mark A. Marostica - *China Distance Education Holdings Limited - Co-CFO*

In the first quarter of fiscal 2019, our net revenue increased by 18.8% year-over-year to \$42.6 million, exceeding the high-end of our guidance range, which marks an encouraging start for the year. The higher-than-expected topline performance was driven by our core accounting vertical, together with our legal vertical, attributable to Beijing Ruida.

Zhengdong Zhu - *China Distance Education Holdings Limited - Co-Founder, Chairman of the Board of Directors & CEO*

(foreign language)

Mark A. Marostica - *China Distance Education Holdings Limited - Co-CFO*

Cash receipts from online course registration maintained strong growth momentum during the quarter, up approximately 50% to \$60.5 million, compared with the same period of last year. Contributing to our first quarter cash-receipt growth was robust growth of cash receipts from our core verticals of accounting in health care and more student enrollments in our longer duration, premium and elite classes.

Zhengdong Zhu - *China Distance Education Holdings Limited - Co-Founder, Chairman of the Board of Directors & CEO*

(foreign language)

Mark A. Marostica - *China Distance Education Holdings Limited - Co-CFO*

Total enrollments increased by 4.6% year-over-year during the first quarter, primarily due to growth in accounting and engineering and construction or E&C Continuing Education enrollments.

Zhengdong Zhu - *China Distance Education Holdings Limited - Co-Founder, Chairman of the Board of Directors & CEO*

(foreign language)

Mark A. Marostica - *China Distance Education Holdings Limited - Co-CFO*

Next, as previously disclosed, we decided to dispose a 60% equity interest in our Tax School Program to the entity's operating team, which can be more flexible in formulating future business development strategies. The transaction was completed in December 2018 and we recognized a gain from deconsolidation of \$6.9 million.

Zhengdong Zhu - *China Distance Education Holdings Limited - Co-Founder, Chairman of the Board of Directors & CEO*

(foreign language)

Mark A. Marostica - *China Distance Education Holdings Limited - Co-CFO*

Turning to recently acquired Beijing Ruida, a leading provider of exam preparation services for China's national legal profession qualification examination, we are pleased report Beijing Ruida contribute to revenue of approximately \$6.8 million in the first quarter. We've been working closely with Ruida to further enhance its online presence, through capabilities by leveraging our extensive experience and robust technologies for online course delivery.

Zhengdong Zhu - *China Distance Education Holdings Limited - Co-Founder, Chairman of the Board of Directors & CEO*

(foreign language)

Mark A. Marostica - *China Distance Education Holdings Limited - Co-CFO*

We believe there are significant synergies between Beijing Ruida's legal professional education platform and our strong online capabilities. Our collaboration with Ruida will ultimately enable Ruida to deliver its legal education content to a broader audience, while extending our offerings into a fourth core vertical, legal, and further diversifying our business model.

Zhengdong Zhu - *China Distance Education Holdings Limited - Co-Founder, Chairman of the Board of Directors & CEO*

(foreign language)

Mark A. Marostica - *China Distance Education Holdings Limited - Co-CFO*

Last week we announced that Zhengbao Yucai, our controlled company listed on the New Third Board, the over-the-counter stock exchange in China, filed an application to voluntarily delist its shares from the New Third Board. Given the thin liquidity of Zhengbao Yucai's shares and the lack of fund-raising opportunities on the New Third Board, Zhengbao Yucai decided to delist from the new third board to facilitate better alignment with its operational and strategic needs.

Note that we will continue to consolidate Zhengbao Yucai's operating results in our consolidated financial statements after Zhengbao Yucai delists its share from the New Third Board.

Zhengdong Zhu - *China Distance Education Holdings Limited - Co-Founder, Chairman of the Board of Directors & CEO*

(foreign language)

Mark A. Marostica - *China Distance Education Holdings Limited - Co-CFO*

I would next, like to provide a few operational highlights.

Zhengdong Zhu - *China Distance Education Holdings Limited - Co-Founder, Chairman of the Board of Directors & CEO*

(foreign language)

Mark A. Marostica - *China Distance Education Holdings Limited - Co-CFO*

Recently we launched the blockchain technology based Link100 Professional Ability Chain in collaboration with Oracle. Link100 is a comprehensive service platform that records and verifies an individual's educational background, professional training and test results information using blockchain technology. Blockchain technology is able to facilitate the validation of individual job qualifications with reliable endorsements and promote fair competition among working professionals. This service platform has been fully developed and will undergo testing in the near future.

Zhengdong Zhu - *China Distance Education Holdings Limited - Co-Founder, Chairman of the Board of Directors & CEO*

(foreign language)

Mark A. Marostica - *China Distance Education Holdings Limited - Co-CFO*

As of December 31, 2018, China Distance Education offered 68 mobile apps and recorded accumulative downloads of \$48.8 million, up from \$44.8 million as of September 30, 2018.

In the first quarter daily traffic to our mobile website continued to increase with daily active users in our accounting vertical increasing by 37.3% year-over-year.

Further, our live streaming courses, which are designed for students who desire a more interactive learning experience, are popular among our students.

Zhengdong Zhu - *China Distance Education Holdings Limited - Co-Founder, Chairman of the Board of Directors & CEO*

(foreign language)

Mark A. Marostica - *China Distance Education Holdings Limited - Co-CFO*

This concludes my update on our business operations and strategy. I will now turn the call over to Mark, our co-CFO, to walk through key operating metrics and financials.

Mark A. Marostica - *China Distance Education Holdings Limited - Co-CFO*

Before I discuss the details of our first quarter financial performance, I would like to provide some additional color regarding FASB's new revenue recognition accounting standard called ASC 606, Revenue from Contracts with Customers, which we adopted on October 1st, 2018.

I'll follow with a discussion of ASC 606 with comments on the key drivers of our first quarter operating loss and operating margin outlook.

ASC 606 presents near-term headwinds for year-over-year revenue growth in Q1 and Q2 of fiscal 2019, primarily due to our inability to recognize lump-sum deferred revenue from premium classes, upon release of related exam results and the expiration of students rights to retake the courses, as we have in prior periods.

Beyond the first half of fiscal 2019, however, ASC 606 will provide a net benefit to our financial results, as cash receipts from our longer duration programs can be organized more evenly over the expected service period. Whereas, under ASC 606's predecessor, ASC 605, a significant portion of revenue was deferred until much later in the service period. And we can now capitalize and amortize commission fees of obtaining a student contract over the service period, rather than recognize these commission fees upfront, as was the case under ASC 605.

We recorded an operating loss in our first quarter, primarily due to the amortization expenses of intangibles arising from the acquisition of Beijing Ruida of \$1.7 million, an increase in rental expenses from our new Anhui Qiao office location in Beijing, higher commissions to agents and higher advertising and promotional expenses.

Despite the first quarter operating loss, we continue believe we will expand operating margins in fiscal 2019 on the back of our expectation of healthy revenue growth in the fiscal year, coupled with the implementation of certain expense-control measures. We also expect to get better leverage on rental expense with the anniversary in our third quarter fiscal quarter of the rise in our rental expense tied to our new office location in Beijing, and our decision to exit certain leased space at our Haidian headquarters, as we moved certain staff to Anhui Qiao.

Now let me summarize some our key operating metrics on Slide 6 and 7. Enrollments in our Online Accounting Test Preparation courses were down 9.4% year-over-year in the first quarter, primarily due to declines in Certified Public Accountant, or CPA, enrollments as well as Accounting Professional Qualification Exams, or APQE, enrollments. Of note, we faced tough year-over-year comparisons in the first quarter of fiscal 2019, for both CPA and APQE enrollment growth, which were up 38% year-over-year and 72% year-over-year in the first quarter of fiscal 2018, respectively.

Enrollments in our Accounting Continuing Education courses increased by 2.9% year-over-year in the first quarter of fiscal 2019.

Total Online Accounting Test Preparation ASPs increased by 75.6% year-over-year in our first quarter. As ASPs increased significantly in our CPA, APQE and tax agent courses. These ASP increases were mainly due to increased student enrollments in our longer duration premium and elite classes.

Enrollments in our Online Healthcare Test preparation courses in the first quarter of fiscal 2019, increased by 15.6% year-over-year. ASPs for our health care test preparation courses increased by 24.9% year-over-year in the first quarter, mainly due to overall ASP increases and, in particular, more student enrollments in longer duration classes of our licensed pharmacist courses, which were offered at relatively higher price points.

Enrollments in our online Engineering and Construction, or E&C, test preparation courses, decreased by 24.9% year-over-year in the first quarter, primarily due to enrollment declines in our cost valuator as well as our associate constructor and constructor test preparations.

Enrollments in our E&C continuing education courses, however, increased by 51.9% year-over-year in the first quarter, mainly due to seasonality. ASPs for our E&C test preparation courses in the first quarter increased by 39.1% year-over-year, primarily due to increased student enrollments in our longer duration premium classes.

The ASPs for E&C continuing education courses decreased by 10.1% year-over-year in the first quarter.

Let's turn to Slide 10 to look at some of our financial metrics. To be mindful of the length of our earnings call, I'll focus on key financial highlights and encourage listeners to refer to our earnings press release and financial filings for further details.

Non-GAAP gross margin was 40% in the first quarter of fiscal year 2019, compared with 48.9% in the first quarter of fiscal year 2018. The year-over-year decline in gross margin was primarily due to expenses associated with Beijing Ruida, including amortization expenses of intangible rising from the acquisition of Beijing Ruida, increased rental and related expenses associated with the company's new office space in Beijing and offline training courses, and increased salaries and related expenses.

The softer growth in revenue from online education services due to the adoption of ASC 606, as discussed in our earnings release, also adversely impacted our non-GAAP gross margin.

Non-GAAP selling expenses increased by 59% to \$14.5 million in the first quarter of fiscal year 2019 from \$9.1 million in the prior-year period, driven primarily by an increase in advertising and promotional expenses, higher commissions to our agents, expenses associated with Beijing Ruida and other miscellaneous selling expenses.

Non-GAAP general and administrative expenses increased by 28.4% to \$5.9 million in the first quarter of fiscal year 2019, up \$4.6 million in the prior-year period, mainly due to the provision for doubtful debts associated with our Accounting Continuing Education and Legal Education businesses, and expenses associated with Beijing Ruida.

Overall, the non-GAAP operating loss for the first quarter of fiscal year 2019 was \$1.7 million, compared with non-GAAP operating income of \$5.6 million in the prior-year period.

We recorded a \$6.9 million gain on the previously announced disposal of 60% equity interest in the Tax School Program in the first quarter of fiscal 2019, and fair value change of the remaining 40% equity interest.

Income tax expense was \$1 million in the first quarter of fiscal year 2019 compared, with \$671,000 in the prior year period primarily, due to an increase in taxable income.

Non-GAAP net income increased to \$2.4 million from \$596,000 in the prior year period.

Now let's turn to Slide 11 to review our cash flow. Net operating cash inflow increased by 101.6% to \$26.6 million in the first quarter of fiscal year 2019 from \$13.2 million in the prior year period. The operating cash inflow was mainly attributable to the decrease in accounts receivable and deferred tax assets and the increase in deferred revenue generated from our professional education services segment, and the amount due a related party.

The operating cash inflow was partially offset by this increase in inventories, prepayments and other current assets, other noncurrent assets, and the decrease in accrued expenses and other liabilities and refundable fees.

Cash and cash equivalents, restricted cash and short-term investments as of December 31, 2018, increased by 10.9% to \$110.5 million from \$99.6 million, as of September 30, 2018, mainly due to the operating cash inflow generated in the first quarter of fiscal 2019, partially offset by capital expenditures at \$7.5 million, mainly relating to our new office space in Beijing and new office building in Xiamen, as a repayment of an offshore loan of \$5 million.

This completes my financial overview. I will now return the call to Mr. Zhu for concluding remarks as well as financial guidance for both the second quarter and for fiscal year 2019. Mr. Zhu, please go ahead.

Zhengdong Zhu - *China Distance Education Holdings Limited - Co-Founder, Chairman of the Board of Directors & CEO*

Thank you, Mark. (foreign language)

Mark A. Marostica - *China Distance Education Holdings Limited - Co-CFO*

With fiscal 2019 well underway, we are focused on enhancing our lifelong learning ecosystem, which now covers 4 core educational verticals, including accounting, health care and engineering and construction, and more recently, legal.

While our mandate has broadened over the years, we strive to partner with our students to help them obtain highly sought-after professional certifications through effective exam preparation courses and services, well positioning our students for career achievement and success. We remain committed to enhancing our students' learning experience by providing superior educational content and services, top lectures and tutors, an innovative online learning platform as well as multiple learning modalities to appeal to individual learning styles.

Zhengdong Zhu - *China Distance Education Holdings Limited - Co-Founder, Chairman of the Board of Directors & CEO*

(foreign language)



Mark A. Marostica - *China Distance Education Holdings Limited - Co-CFO*

We continue to expect to generate non-GAAP operating income growth in fiscal 2019, with improved non-GAAP operating margins, while a balanced growth with a key focus on prudent cost control. And we are pleased to report that we are seeing continued strong growth momentum in cash received from online course registration, which increased by approximately 45% year-over-year on a constant-currency basis, during the second quarter of fiscal 2019, through the end of February 2019.

Zhengdong Zhu - *China Distance Education Holdings Limited - Co-Founder, Chairman of the Board of Directors & CEO*

(foreign language)

Mark A. Marostica - *China Distance Education Holdings Limited - Co-CFO*

Turning to guidance. For the second quarter of fiscal year 2019, the company expects to generate total net revenue in the range of \$33.3 million to \$34.8 million, representing year-over-year growth of approximately 12% to 17%.

Zhengdong Zhu - *China Distance Education Holdings Limited - Co-Founder, Chairman of the Board of Directors & CEO*

(foreign language)

Mark A. Marostica - *China Distance Education Holdings Limited - Co-CFO*

For the fiscal year 2019, the company expects to generate total net revenues in the range of \$208.3 million to \$216.7 million, representing year-over-year growth of approximately 25% to 30%.

Zhengdong Zhu - *China Distance Education Holdings Limited - Co-Founder, Chairman of the Board of Directors & CEO*

(foreign language)

Mark A. Marostica - *China Distance Education Holdings Limited - Co-CFO*

This concludes my prepared remarks. Thank you for your time. Operator, we are now happy to take questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) If there are no questions, I would like to turn the call back to management for closing remarks.

Mark A. Marostica - *China Distance Education Holdings Limited - Co-CFO*

Thank you, operator. On behalf of the management team, we thank you for joining us today, and we look forward to updating you on our progress.



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