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RYB.N - Q1 2019 RYB Education Inc Earnings Call

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CORPORATE PARTICIPANTS

Hao Gu

Serena Xue *RYB Education, Inc. - Manager of IR*

Wei Ping *RYB Education, Inc. - CFO*

Yanlai Shi *RYB Education, Inc. - Co-Founder, CEO & Executive Director*

CONFERENCE CALL PARTICIPANTS

Jack Chang *BNP Paribas Cardif TCB Life Insurance Company Ltd. - Chief Executive*

Kin Man Wong *Jefferies LLC, Research Division - Equity Analyst*

X. Liu *Crédit Suisse AG, Research Division - Analyst*

Yiran Sheng *Morgan Stanley, Research Division - Equity Analyst*

PRESENTATION

Operator

Hello, ladies and gentlemen. Thank you for standing by for RYB Education Inc.'s First Quarter 2019 Earnings Conference Call. (Operator Instructions) Today's conference call is being recorded.

I will now turn the call over to your host, Ms. Serena, Investor Relations Manager for the company. Please go ahead, Serena.

Serena Xue - *RYB Education, Inc. - Manager of IR*

Thank you, operator. Please note, the discussion 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 involve inherent risks and uncertainties. As such, the company's actual results may be materially different from the views expressed today. Further information regarding these and other risks and uncertainties is included in the company's annual report on Form 20-F for the fiscal year ended December 31, 2018, and other filings as filed with the U.S. Securities and Exchange Commission. The company does not assume any obligation to update any forward-looking statements except as required under applicable law.

During today's call, management will also discuss certain unaudited non-GAAP financial measures for informational purposes only. The company's press release for first quarter 2019 earnings contains a reconciliation of the unaudited non-GAAP measures to the unaudited most directly comparable GAAP measures. As a reminder, this conference is being recorded. A webcast replay of this conference call will be available on the company's corporate website at ir.rybbaby.com.

On today's call is Ms. Yanlai Shi, Cofounder, Director and Chief Executive Officer of the company; and Ms. Ping Wei, Chief Financial Officer of the company. I'll now turn the call over to Ms. Shi. Please go ahead.

Yanlai Shi - *RYB Education, Inc. - Co-Founder, CEO & Executive Director*

[Interpreted] We ended first quarter of 2019 with solid performance, delivering 19.2% year-over-year revenue growth. This healthy performance was attributable to our consistent investment in enhancing the quality of education and services we provide to our children and our continuous pursuit of differentiated products and services offerings.

More specifically, we focus on attracting and retaining the best top talent, particularly our teachers, consistent investments in proprietary course research and developments, enhanced staff and teacher training, safety protocol standardization update and our open-door policy and participatory programs for parents. All of these quality and service improvement measures collectively helped us better cater to customer demand for high-quality education products and services offerings.

We have a proven track record in providing quality educational services. With the government policies and regulations relating to early childhood education services continuing to be implemented this year, we're working alongside relevant government agencies to integrate those policies at our facilities. We're consistently committed to providing high quality and differentiated early childhood education in China and support the government policies that make kindergarten and all early childhood services of high quality, affordable, accessible and safe.

Moving onto our strategy and operational updates. We aim to strike a balance between growth and profitability as well as between focus and diversification within the framework of our -- of current policies and regulations.

We have seen and will continue to drive growth in the following 5 business areas: play-and-learn centers, or PLCs; directly operated kindergartens; services to third-party kindergarten operators; childcare for the age of 0 to 3 years old; and other new initiatives, including quality-oriented education.

Our play-and-learn centers offer engaging classes and appropriate course content designed for joint participation by children 0 to 6 years old and their adult family members. These classes promote the children's development while fostering bonding with family members and preparing the kids for entry into kindergarten or primary schools.

At the end of the first quarter, we had over 1 -- we had 1,110 franchise play-and-learn centers in operation. The strength of our play-and-learn centers lie with the ever-evolving, high-quality courses we offer supported by our strong curriculum research and development capabilities. This quarter, we rolled out yet another new feature course and upgraded a popular course offering. Such new courses and upgrades are well received by our network of franchisees. These not only solidified RYB's leadership position in this market, it as well expanded product and services revenue potential both for our franchisees and us.

In addition to high-quality courses, we also offer comprehensive trainings to ensure quality of educational services delivered across our centers are consistent. Started last year, we further worked to improve our internal capabilities in helping our franchisees to improve their sales and marketing capabilities to achieve better operational results. With such efforts, we hope to help them better capture market opportunities and achieve ultimate business success.

Such initiatives worked out well. Riding on the momentum, we introduced the new revenue-sharing franchise model last year. This new model, which carries with it a 6% to 8% revenue-sharing scheme at a minimum fixed fee to RYB, has been well received and number of contracts signed under the new arrangement so far has exceeded 160, representing a vast majority of new franchise contracts signed since July last year. Existing franchisees have the option to convert to the new model at their discretion or pay a higher fixed annual fee upon contract renewal. Backed by our strong curriculum R&D, franchisee training systems and enhanced sales, marketing and operational support, we expect to build closer ties with our franchisees and deliver strong revenue and profit growth for our play-and-learn center franchise operations over the coming years.

Moving to kindergarten, we ended the first quarter with 24,572 students as compared to 22,087 students as of March 31, 2018. In the first quarter of 2019, despite our efforts in optimizing our kindergarten portfolio, where we sold 5 kindergartens to the minority shareholders of the facilities and resulted in a reduction of about 1,000 students. The company registered 2,485 student inquiries compared to the first quarter of last year and a 945 net increase as compared to the previous quarter. We believe this growth is attributable to our continuous efforts in providing high-quality, differentiated, early childhood education services.

Looking ahead, we're confident that student enrollment for this year will stay healthy, thanks to our continued investments in quality and a favorable demographic trend.

While our existing core business, namely directly operated kindergartens and franchise play-and-learn centers, is well on track to delivering healthy performance. We also proactively assess new market opportunities and accordingly executed our strategies for building new business lines. For example, we view kindergarten management services as a viable model with untapped business potential. Under this model, we serve third-party kindergarten operators by providing management advisory services, curriculum packages, curriculum-related training and operational quality supervision. This model allows us to further grow our businesses without much of the infrastructure and operational expenses that go along with brick-and-mortar physical locations.

Another new business area I mentioned earlier is childcare and education for the age of 0 to 3 years old. As briefly discussed in our last earnings call, we believe this market segment is underserved and holds huge unmet demand. Moving into this arena of children services is a natural extension that allows us to capitalize on our core strengths and expertise in curriculum research and development, teacher training and standardized operating procedures from our existing operations. At present, we plan to first launch operations at our pilot center in Shanghai, and we're on track to open 2 directly operated centers later this year.

Finally, let me briefly touch upon our other initiatives. Selective acquisitions are an example. In February 2019, we entered into a definitive agreement to acquire a controlling shareholders' interest in a leading Singapore-based private childhood education group. We're very excited to have recently closed on this acquisition and by doing so, we have expanded our directly operated kindergarten network and brand universe considerably. The highly professional team and the bilingual curriculum that came with the Singapore acquisition, together with other smaller acquisitions that we did, also have positioned us well to offer broader and better product and services, such as proprietary course content, teacher training, management systems and standards and other tailored service solutions. The Singapore acquisition as well as our infant care and education initiative exemplifies our ability to move forward to servicing a wider target market, both at home and abroad.

To close, we believe the early childhood education market in China is still in the early stages of development, and there is a long runway ahead. We're confident to capture growth opportunities that lay ahead. Our founding mission, which is to provide high-quality individual life and age-appropriate care and education that nurtures and inspires each child to reach his or her full potential, has not changed since the first day we opened our doors more than 20 years ago. With our mission in head -- in mind, we will improve ourselves by attracting and retaining talent, enhancing management operations and IT systems and ultimately, building a truly topnotch early childhood education platform. We firmly believe that our balanced growth strategy is both focused and extensive through dedicated execution. We both -- we can both create long-term shareholder value and deliver social benefits to kids and families.

With that, I'll turn it over to Mr. Wei Ping to provide details of our first quarter financial results.

Wei Ping - *RYB Education, Inc. - CFO*

Thank you, Grace. Please refer to our press release for more complete discussions about our financial performance. I will only provide some highlights so we can have some time for Q&A. 2019 began with net revenues increasing 19.2% year-over-year in the quarter despite currency headwinds. On R&D terms, our net revenues actually grew 26.5%. Enrollment at directly operated kindergartens also grew 11.3% in the quarter.

In addition, first quarter adjusted operating loss narrowed to $2.7 million from $3.4 million in the first quarter of last year. Our improving top line and bottom line results were driven by focused execution of our growth strategy, prudent cost management and our continuous investment in offering more quality products and services solutions. We believe such a balanced approach will help optimize long-term shareholder value.

Net revenues for the first quarter of 2019 increased by 19.2% to $34.3 million from $28.8 million for the same quarter of 2018. Service revenues for the first quarter of 2019 increased by 22.5% to $31.9 million from $26 million for the same quarter of 2018. The increase was primarily due to increased tuition fee from increased average student payments due to student mix shift and an increase in the number of students enrolled in the company's directly operated kindergartens. The increase in the number of students enrolled was attributable to newly opened facilities, acquired facilities as well as higher utilization rates at existing facilities as they ramp up.

Product revenues for the first quarter of 2019 decreased by 12.1% to $2.4 million from $2.8 million for the same quarter of 2018. The decrease was mainly timing difference as some products typically delivered in the quarter were delayed to later quarter.

Cost of revenues for the first quarter of 2019 was $32.4 million, a 15.3% increase from $28.1 million for the same quarter of 2018. Cost of revenues for services for the first quarter was $31.2 million compared with $26.7 million for the same quarter of 2018. The increase was primarily due to increase in staff compensation at the company's directly operated kindergartens and higher operating costs, such as rental and material consumptions as the company's kindergarten facilities network expanded in the quarter. Cost of products revenue for the first quarter of 2019 was $1.2 million compared with $1.4 million for the same quarter of 2018. The decrease was generally in line with the decrease in product revenues.

Gross profit for the first quarter of 2019 increased by 195% to $1.8 million compared with $0.6 million for the same quarter of 2018. Gross margin for the first quarter of 2019 was 5.24% compared with 2.2% for the same quarter last year. The increase was primarily due to incrementally higher utilization rates at directly operated kindergartens and increased tuition fees from a student mix shift.

Total operating expenses for the first quarter of 2019 were $5.9 million comparable with $5.8 million for the first quarter of 2018. Excluding share-based compensation expenses, operating expenses were $4.6 million, an increase of 13.1% from $4.1 million for the first quarter of 2018.

Salary expenses for the first quarter of 2019 were $0.6 million compared with $0.3 million for the same quarter of 2018.

General and administrative expenses for the first quarter of 2019 were $5.3 million, a 3.1% decrease from $5.5 million for the same quarter of 2018. Excluding share-based compensation expenses, G&A expenses were $4 million compared with $3.8 million for the same quarter of 2018. The share-based compensation expenses included in G&A expenses were $1.3 million for the first quarter of 2019.

Operating loss for the first quarter of 2019 was USD 4 million, compared with $5.1 million for the same quarter last year. Adjusted operating loss was $2.7 million for the first quarter of 2019 compared with $3.4 million for the same quarter of 2018.

Net loss attributable to ordinary shareholders of RYB for the first quarter of 2019 was $2.3 million compared with $2.7 million for the same quarter of 2018. Adjusted net loss attributable to ordinary shareholders of RYB, which excludes the impact of $1.3 million of share-based compensation expense and $0.2 million decrease in redeemable noncontrolling interests for the first quarter of 2019, was $1.2 million compared with $1 million for the same quarter of 2018.

Basic and diluted net loss per American depositary share, or ADS, attributable to ordinary shareholders of RYB for the first quarter of 2019 were both $0.08 compared with $0.09 for the same quarter of 2018. Each ADS represents 1 Class A ordinary share. Adjusted basic and diluted net loss per ADS attributable to ordinary shareholders of RYB for the first quarter of 2019 were both $0.04 compared with $0.03 for the same quarter of 2018.

EBITDA for the first quarter of 2019 was a loss of $0.7 million compared with a loss of $2.8 million for the same period of 2018. Adjusted EBITDA for the first quarter of 2019 was $0.6 million compared with a loss of $1 million for the same quarter of 2018.

Cash generated from operating activities was USD 13.2 million during the first quarter of 2019 compared with $5.3 million during the first quarter of 2018. The increase was primarily due to higher advanced payments from customers in the quarter as compared to the last year, further enlarged by one-off refunds to potential and contracted franchisees in the same quarter of 2018. As of March 31, 2019, the company had total cash and cash equivalents of $100.1 million, a decrease from $104.1 million as of December 31, 2018, as operating cash inflow generated from this quarter was used in acquisition and other investment activities. $4.5 million worth of share repurchase executed in the quarter also contributed to the decrease of cash balance.

With that, I would like to turn the call back to Grace to discuss the business outlook.

Yanlai Shi - *RYB Education, Inc. - Co-Founder, CEO & Executive Director*

[Interpreted] Thank you, Ping. For the second quarter of 2019, the company's management currently expects net revenues to be between USD 52.1 million and 20 -- USD 54.5 million, representing a year-over-year increase of approximately 10% to 15%.

I'd like to point out in particular that our second quarter guidance reflects consideration of 2 important elements. First, there has been a dramatic change in the exchange rate. For the first quarter of 2018, USD 1 averages to approximately CNY 6.35. Yesterday, USD 1 is priced at approximately CNY 6.9 by the People's Bank of China. Second, in 2018, the company adopted ASC 606 applying the modified retrospective method to franchise contracts not completed as of the beginning of 2018. The result from adopting that policy was that the company's franchise revenue for the second quarter of 2018 increased significantly due to the recognition of initial franchise fee revenue over the service period creating tough comparison year-to-year.

For the full year of 2019, the company's management raises its previously stated guidance. We currently expect net revenues to be between USD 195.5 million and USD 203.5 million, representing a year-over-year increase of approximately 25% to 30%.

The above outlook is based on the current market conditions and reflects the company management's current and preliminary estimates of market and operating conditions, customer demand and foreign exchange environment, which are all subject to change. The above outlook includes revenue consideration of the company's completed acquisition of a leading Singapore-based private childhood education group as initially announced February 5, 2019.

Finally, I would like to mention Ping has, for her personal reasons, decided to step down from her role as CFO and will continue to serve the company as a senior adviser. On behalf of the Board of Directors and management team, I would like to thank her for her work and contributions at RYB and look forward to continue to work with her in her new advisory role with the company.

We'd also like to warmly welcome Hao Gu to the company and as our Chief Financial Officer effective June 1, 2019. We look forward and expect Hao Gu with his comprehensive leadership experience in corporate financing and investments and deep financial background to create greater value for the company and our shareholders in the future.

Wei Ping - *RYB Education, Inc. - CFO*

Thank you, Shi. The past 2 years have been both challenging and rewarding to me. And thank you to the entire Board for your support and guidance. And thanks to my analysts and shareholders as well for all your support in the past 2 years. I really enjoyed working with you, and I really enjoyed our journey together. But rest assured that I will continue to serve the company in my new role as an -- as a senior adviser for the company and we'll be in touch.

Hao Gu

Thank you, Ping. And good evening, everyone or good morning. This is Hao Gu here. I'm very honored and excited to join RYB as Chief Financial Officer. I actually have tremendous respect for the company's senior management team and for what they have achieved in the early childhood education industry in China. The mission to provide individualized, age-appropriate, high-quality education to children is very important to me. I'm looking forward to helping lead the company as we continue to deliver social benefits to kids and families, capture growth opportunities in this great and exciting marketplace and deliver long-term shareholder value. And thank you everyone for your continued support and interest in RYB.

Serena Xue - *RYB Education, Inc. - Manager of IR*

Thank you for your attention. We'll now open the call to questions. Operator, please go ahead.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question today comes from Elsie Sheng with Morgan Stanley.

Yiran Sheng - *Morgan Stanley, Research Division - Equity Analyst*

This is Elsie, on behalf of Sheng Zhong. I have two questions. The first question is, I'm happy to hear that you have many new developments in terms of your new business, like early children care. I'd like to know what would be the impact on management from the rollout of the new business? Second question is that I noticed that you have a very strong enrollment in the first quarter. What's the management's take of the future trends of enrollment? Will the momentum continue in the next few quarters?

Wei Ping - *RYB Education, Inc. - CFO*

Elsie, I'll take both questions and thanks for the questions, I think they are good ones. On the 0- to 3-year-old market, we do expect it to require some investment to quantify it. We expect to invest, for this year, slightly less than RMB 10 million of net loss in sort of kickstarting initiating curriculum development sort of opening up 2 direct-owned centers this year. All those included, we expect to lose not more than RMB 10 million in the year. However, we expect it to turn profitable right away in 2020, starting to contribute to both our top line and bottom line sort of accretively.

Secondly, other than the 0- to 3-year-old, sort of, earlier care and education initiatives, the other new initiatives such as a non-direct-owned kindergarten sort of a vertical and other we call quality education area because we are all riding on our historical accumulation of experience, channels, platform, et cetera. Even though they are considered new initiatives, we don't expect them to lose money. In fact, they are going to be bottom line positive first year this year, and -- this is the first year, so this year, and it will be even more profitable going forward. That's why we actually not only expect this year sort of net margin on non-GAAP basis without Singapore to be at least similar to last year or most likely will be better than last year, and we actually expect next year without Singapore again in our non-GAAP bottom line will probably double. So that's for the first question.

Second question is almost like proving my point on our sort of good progress on new initiatives, we also do very well on the existing core verticals. With kindergarten and as Hao Gu mentioned, the net increase of new enrollments this quarter is 945 students, but the comparison base from December 31 was artificially inflated because with the disposition of 6 facilities the -- if we are comparing apples to apples from December 31 to March 31, we actually had a net increase of over 2,000 new students or new enrollments, which is almost 10% of our existing student base. So one, the first quarter we did very well with kindergarten student enrollment. Two is, we also expect this to stay strong proven by -- basically one is, we do have a favorable demographic trend particularly for this year as kids enrolling in kindergarten for this year are kids that were born in 19 -- sorry, 2016, the first year after the 1 child policy was fully relaxed to allow any families to have 2 children. Thirdly, just to prove my point that our forward trend on kindergarten enrollment will be strong is that from end of March to end of last week, in less than 2 months, we had another new addition of close to another 1,000 new students. So that's sort of -- as long as the strength continues for this year, we'll do very well. I hope that answers your question, Elsie.

Yiran Sheng - *Morgan Stanley, Research Division - Equity Analyst*

Okay. Thank you very much.

Operator

Our next question today comes from Ivy Liu on for Alex Xie with Crédit Suisse.

X. Liu - *Crédit Suisse AG, Research Division - Analyst*

My question is what is management's current strategy for M&As in the future? And specifically, what kind of targets have you considered or reviewed? And will management continue to pursue overseas M&As in the future?

Wei Ping - *RYB Education, Inc. - CFO*

Okay. I will take that question directly. Our -- basically, we have always had a selective M&A strategy basically for a few years now actually. The goal is to acquire accretively. The goal is to acquire M&A target that has strategic value to us in addition to being -- having sort of a good accretive valuation to us. With this, we -- sort of we did quite a few M&A last year and into this year, we also -- I think, we already did a few small ones, okay? Because they're small, we actually didn't sort of separately announce them. So going forward, you see we still have USD 100 million cash sitting on our balance sheet. We have negative working capital requirements, meaning any cash we have on balance sheet technically is excess cash plus the advance payments from franchisees and students actually fund our operations overall. So we continue our M&A sort of initiative. However, I think one touchy point is with the new opinion that came out towards end of November last year, can we acquire kindergartens directly in China? I would say, no, we would not pursue that kind of acquisition, but targets are plenty for us to look into other potential growth areas as you see we have 5 key growth areas. Like, they are planned target on the market for non-direct-owned kindergarten services for play-and-learn, for earlier care and education, for quality education, arts education, you name it, 0 to 6 years old is a huge market, lots of potential like at home turf and abroad. So we want to continue to adopt primarily organic but yet supplement it with sort of M&A opportunity kind of growth, and we are -- we're confident that -- especially with the integrations -- successful integrations of past acquisitions, we're confident that this kind of growth strategy will work out well for us. Thank you.

Operator

(Operator Instructions) Our next question comes from Johnny Wong with Jefferies.

Kin Man Wong - *Jefferies LLC, Research Division - Equity Analyst*

Congratulations on the very good set of results. I just have one question. I noticed that on the Bloomberg headlines today, that says that China will give value-added tax exemptions to providers of kindergartens and daycare centers. I was wondering if management has heard about that and if you can give some color on this and how would that help us in terms of our financials.

Wei Ping - *RYB Education, Inc. - CFO*

Thank you, Johnny. I'll take the question directly. Actually, we are exempt from VAT already with our kindergarten tuition revenue. And it certainly is good news for us on the daycare side as we enter into the earlier care and education sector, but we are yet to generate meaningful revenue there. So I will say going forward on the earlier care and education sector we'll also enjoy some benefits on this exemption, but kindergarten we've always been exempt from VAT on our tuition fees. I'd be really happy if they have an income tax reduction as well, but let's see.

Operator

Our next question comes from Jack Chang with BNP Paribas.

Jack Chang - *BNP Paribas Cardif TCB Life Insurance Company Ltd. - Chief Executive*

I have one question here. Could management provide us the utilization rate in directly operating kindergarteners for this quarter and same quarter for last year? And does management have any long-term target on this?

Wei Ping - *RYB Education, Inc. - CFO*

Jack, that's a challenging question for me actually. I do know, clearly, the utilization rate increased for this quarter because we have less facilities with more enrollment. So in terms of exact numbers, it's -- honestly, we do have a few ways to measure utilization. For example, I have a theoretical utilization rate, which is a very simple 20 students per class, sort of, kind of, measurement. But then we have the more sophisticated or complex utilization measurement, which taking into consideration the kind of kindergartens we operate, as you know, we have multi-tiered in-market segmentation. With our international kindergarten, we only have probably less than 20 kids per class at capacity, while at the inclusive kindergarten level, we could have over 30, even 35 students per class for, sort of -- because of the demand. Overall, based on theoretical sort of utilization, we are close to 90% mark. However, if we look at real utilization based on the kind of facilities we run, with the kind of classes we have and the actual maximum number of students, we can take into all the kindergartens, I think right now we are probably only at around 70%, okay? So that actually tells a few things. One is I want you to know that with the real utilization rate, we'll never reach 100%, okay? We probably will max at about 90% to 95%. Two is, 70% to 90%, 95% as well we'll get our margin improvements from -- in the next few years and it is expected that next year, in 2020, we will see improving margins because we are -- we -- actually we'll not open as many new facilities this year and next year and the majority of our revenue growth will come from increasing utilization and increasing sort of per student payment as we move to more premium and high-end kindergarten services. I hope I answered your question, Jack.

Operator

(Operator Instructions) As there are no further questions, now I'd like to turn the call back over to Serena for closing remarks.

Serena Xue - *RYB Education, Inc. - Manager of IR*

Thank you. Thank you all once again for joining us today. If you have any further questions, please do not hesitate to contact us at ir@rybbaby.com. Thank you very much for your time, and we hope you have a wonderful day and night.

Wei Ping - *RYB Education, Inc. - CFO*

Thank you.

Yanlai Shi - *RYB Education, Inc. - Co-Founder, CEO & Executive Director*

Thank you.

Operator

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

[Portions of this transcript that are marked

[Interpreted] were spoken by an interpreter present on the live call.]