THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

COE - Q1 2019 China Online Education Group Earnings Call

EVENT DATE/TIME: JUNE 14, 2019 / 12:00PM GMT

THOMSON REUTERS

CORPORATE PARTICIPANTS

Jiajia Huang *China Online Education Group - Founder, Chairman & CEO*

Judy Piao *China Online Education Group - Head of IR*

Min Xu *China Online Education Group - CFO*

CONFERENCE CALL PARTICIPANTS

Bo Pei *Oppenheimer & Co. Inc., Research Division - Associate*

Roger Parodi - Silverhorn Principal Investors; Managing Partner

Zhonghai Yu *China International Capital Corporation Limited, Research Division - Associate*

PRESENTATION

Operator

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

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

Judy Piao - *China Online Education Group - Head of IR*

Hello, everyone, and welcome to the first quarter earnings conference call of China Online Education Group, also known as 51Talk. The company's results were issued via newswire services earlier today and are posted online. You can download the earnings press release and sign up for the company's distribution list by visiting the IR section of its website at ir. 51talk.com.

Mr. Jack Huang, our Chief Executive Officer; and Mr. Min Xu, our CFO, will begin with some prepared remarks. Following the prepared remarks, Mr. Liming Zhang, our Chief Operating Officer, will also join the call for our Q&A session.

Before we continue, please note that today's discussion 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 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 Form 20-F and other public 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 the applicable law.

Please also note that 51Talk's earnings press release and this conference call include discussions of unaudited GAAP financial information as well as unaudited non-GAAP financial measures. 51Talk's press release contains a reconciliation of the unaudited non-GAAP measures to the unaudited most directly comparable GAAP measures.

I will now turn the call over to our CEO, Jack Huang. Please go ahead.

Jiajia Huang - *China Online Education Group - Founder, Chairman & CEO*

Okay. Hello, everyone. Thank you very much for joining us for our first quarter earnings conference call.

We had a solid start in 2019, with both revenues and gross billings topping the high end of our guidance. Our first quarter results reflect the successful and a consistent execution of our strategies, which focus on our core K-12 one-on-one mass market program in China's lower-tier places. We continue to streamline our business to focus our resources on providing high-quality programs for the growing K-12 market.

Our growth strategy is sharply focused on bringing our programs to China's large and underserved markets in non-Tier 1 cities. Our live online English offerings are a good match to growing demand in Tier 2 and Tier 3 cities. We are capitalizing on this opportunity. We are actively marketing our services here, and it is working.

Our referral rates are growing, as evidenced by our expanding gross billings. In fact, in the first quarter, our gross billing from non-tier 1 cities accounted for an impressive 72.8% of our K-12 mass market one-on-one offerings. This compares to just 53% in the same period 1 year ago.

As we move through the year, our key goal will be to continue to make learning accessible throughout China by bringing out our educational offerings to underserved markets. Based on our model, we can easily leverage our existing programs in these non-Tier 1 cities. We have a stable and a scalable process in place with our foreign teacher operations in the Philippines to support this growth. With our teacher recruiting, training and management systems firmly in place as well as strong local government support, we are confident in our ability to scale our teacher sourcing capabilities as we expected.

As we expand in 2019, we will continue to dedicate resources to increasing the accessibility of our courses, improving our exposure and strengthening the quality of our offerings and technology while achieving balance between growing our top line and improving our bottom line.

So well, with that, I will now turn the call over to our CFO, Xu Min.

Min Xu - *China Online Education Group - CFO*

Thank you, Jack. The diligent execution of our more focused mass market strategy contributed to improve the bottom line and healthy growth in the first quarter. We reduced our non-GAAP net loss by 55.1% to RMB 59.5 million from RMB 132.4 million in fourth quarter 2018.

Our one-on-one business gross billings grew by 37.4% year over year and our overall gross billing -- gross margin reached 67.3%, up from 64.6% for the first quarter of 2018.

In addition, gross billing increased by 28.1% year-over-year -- gross profit increased by 28.1% year-over-year to RMB 217.2 million. Through enhanced sales training and improving sales capacity planning, emphasis on referrals and prudent cost control and cash deployment, we will spur our opportunity for growth while improving our bottom line.

Now I would like to walk you through our first quarter 2019 financial highlights. Net revenues for the first quarter of 2019 were RMB 323.0 million, a 23.0% increase from RMB 262.6 million for the first quarter of 2018. The increase was primarily contributed (sic) [attributed] to an increase in the number of active students. The number of active students in the first quarter of 2019 was approximately 227,000, a 19.2% increase from approximately 190,000 in the first quarter of 2018.

Net revenues from one-on-one offerings for first quarter of 2019 were RMB 295.5 million, a 20.4% increase from RMB 245.5 million for the first quarter of 2018.

Net revenues from small class offerings for first quarter of 2019 were RMB 27.5 million compared with RMB 19.1 million (sic) [RMB 17.1 million] for the first quarter of 2018

Cost of revenues for first quarter of 2019 was RMB 105.7 million, a 13.8% increase from RMB 92.9 million for the first quarter of 2018. The increase was primarily driven by an increase in total service fees paid to teachers, mainly due to an increased number of paid lessons.

Cost of revenues of one-on-one offerings for the first quarter 2019 was RMB 90.8 million, a 12.0% increase from RMB 81.1 million for the first quarter of 2018. Cost of revenues of small class offerings for the first quarter of 2019 was RMB 14.9 million, a 26.1% increase from RMB 11.8 million for the first quarter of 2018.

Gross profit for the first quarter of 2019 was RMB 217.2 million, a 28.1% increase from RMB 169.6 million for the first quarter of 2018. Gross margin for the first quarter of 2019 was 67.3% compared with 64.6% for the first quarter of 2018.

One-on-one offerings gross margin for the first quarter of 2019 was 69.3% compared with 67.0% for the first quarter of 2018. The increase was mainly attributable to the inclusion of the company's audio picture books in course packages, which carries a higher margin. Our small class offering gross margin for the first quarter of 2019 was 45.7% compared with 30.7% for the first quarter of 2018.

Total operating expenses for the first quarter of 2019 were RMB 278.1 million, a 0.7% decrease from RMB 280.2 million for the first quarter of 2018. Sales and marketing expenses for the first quarter of 2019 were RMB 186.3 million, an 8.6% increase from RMB 171.6 million for the first quarter of 2018. The increase was mainly due to higher sales personnel costs related to an increase in the number of sales and marketing personnel.

Excluding share-based compensation expenses, non-GAAP sales and marketing expenses for the first quarter of 2019 were RMB 186 million, a 9.2% increase from RMB 170.4 million for the first quarter of 2018.

Product development expense for the first quarter of 2019 were RMB 40.7 million, a 22.1% decrease from RMB 52.2 million for the first quarter of 2018. The decrease was primarily due to a decrease in the number of personnel. Excluding share-based compensation, non-GAAP product development expense for the first quarter of 2019 were RMB 40.1 million, a 20.8 decrease -- percent decrease from RMB 50.7 million for the first quarter of 2018.

G&A expenses for the first quarter of 2019 were RMB 51.2 million, a 9.2% decrease from RMB 58.4 million (sic) [RMB 56.4 million] for the same quarter last year. Excluding share-based comp, non-GAAP G&A expenses for the first quarter of 2019 were RMB 48.1 million, an 8.4% decrease from RMB 52.6 million for the same quarter last year.

Loss from operations for the first quarter of 2019 was RMB 60.9 million compared with RMB 110.5 million for the first quarter of 2018. Non-GAAP loss from operations for the first quarter of 2019 was RMB 57.0 million compared with RMB 104 million for the first quarter of 2018.

Net loss for the first quarter of 2019 was RMB 63.6 million (sic) [63.3 million] compared with RMB 112.7 million for the first quarter of 2018. Non-GAAP net loss for the first quarter of 2019 was RMB 59.5 million compared with RMB 106.1 million for the first quarter of 2018.

Basic and diluted net loss per ADS attributable to ordinary shareholders for the first quarter of 2019 was RMB 3.15 compared with RMB 5.55 for the first quarter of 2018. Each ADS represents 15 Class A ordinary shares. Non-GAAP basic and diluted net loss per ADS for the first quarter of 2019 was RMB 2.85 compared with RMB 5.25 for the first quarter of 2018.

As of March 31, 2019, we had total cash, cash equivalent, time deposits and short-term investments of RMB 697.1 million compared with RMB 712.1 million as of December 31, 2018. As of March 31, 2019, we had deferred revenues of RMB 1.8 billion compared with RMB 1.7 billion as of December 31, 2018.

So for the second quarter of 2019, the company currently expects net revenues to be between RMB 342 million to RMB 347 million, which represents an increase of approximately 21.4% to 23.2% from our RMB 281.7 million for the same quarter last year. Total gross billings to be between RMB 465 million to RMB 470 million, which would represent an increase of approximately 10.7% to 11.9% from RMB 420 million for the same quarter last year.

Gross billings for the company's one-on-one business are expected to be between RMB 433 million to RMB 438 million, which would represent an increase of roughly 15.0% to 16.3% from RMB 376.5 million for the same quarter last year. Gross billings for our small class business are expected to be approximately RMB 32 million, which would represent a decrease of approximately 26.4% from RMB 43.5 million for the same quarter last year.

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

This concludes our prepared remarks. We will now open the call to questions. Operator, please go ahead.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) The first question comes from Bo Pei of Oppenheimer.

Bo Pei - *Oppenheimer & Co. Inc., Research Division - Associate*

I have 2 questions here. One is we gained pretty good operational leverage in 1Q. And then could you kind of explain what was the reason behind that operating leverage gain? And then should we expect the operating expenses as a percentage of total revenue continue to go down throughout 2019?

And then my question number two is for your 2Q guidance, that actually implies a sequential deceleration of the gross billing. Could the management give more color on that?

Min Xu - *China Online Education Group - CFO*

Thank you for the question. So number one, we did see a good leverage -- the good operating leverage because we are working very hard. As we indicated in the last few earnings call, we're working very hard to improve our sales efficiencies. And in fact, we did achieve that through a lot of the operation optimization. And so we believe the key is that we really start to see efficiency improvement in our sales marketing. And our Q1 non-GAAP sales and marketing expenses was 39% of our gross billings for our one-on-one business, much better than 48% in Q1 2018. And we believe we are -- we're going to see the benefit of our previous optimization and efficiency improvement measures, and we will continue to improve that.

And for the second question, you mentioned that our Q2 guidance indicated a de-acceleration of our gross billing. So I would say in a sense, yes, from the number we do see is slowing down compared to Q1. However, remember, Q1 we are comparing to a relatively weak 2018 Q1 quarter. And so it is hard to kind of continue that kind of growth. So we do see our -- because we're seeing continued growth improvement throughout 2019. So starting Q2, we are comparing to a much better performance in terms of our gross billing. So we do expect our healthy growth to continue and drive our non-Tier 1 city expansion. And we do expect that as we continue to deepen our penetration in non-Tier 1 cities, we will see continued growth while improving our bottom line.

Operator

The next question comes from name from Zhonghai Yu of CICC.

Zhonghai Yu - *China International Capital Corporation Limited, Research Division - Associate*

(foreign language) So my first question is the same question that how do you see the trend of your user acquisition costs? Is it going up or down? Like can you give a like brief range of like they rose by about 5% over same time Y-O-Y, like this.

And then my second question is about the competitive landscape. While given that we have better unique positioning than we have in the Tier 3 to Tier 4 cities, who do we see as our main competitors? And how is it going between we and other players?

Min Xu - *China Online Education Group - CFO*

Thank you, Zhonghai.

Jiajia Huang - *China Online Education Group - Founder, Chairman & CEO*

(foreign language)

Min Xu - *China Online Education Group - CFO*

So I will answer the first question, and Jack will answer the second question. So in terms of customer acquisition cost, we're seeing is quite stable compared to the past few quarters. We did see a slight improvement in terms of our marketing efficiency. And we are seeing kind of a stable conversion cost. So it is relatively stable throughout the year.

And I'll hand over to Jack for the second question.

Jiajia Huang - *China Online Education Group - Founder, Chairman & CEO*

Okay. (foreign language)

Min Xu - *China Online Education Group - CFO*

[Interpreted] Okay. So I'll translate. So starting 2019, we're seeing trends that the VC market is cooling down. And so a lot of our competitors are less crazy burning cash to -- trying to grow their business. So we have to say the intensity of competition is much lower, and it's a much healthier environment for us. As you know, many of our competitors, they use North American teachers. So their price is 3x of our price. So we -- our offering are much more attractive in lower-tier cities. So we can achieve much better penetration there as you see from the number, that 73% of our core business gross billings are from non-Tier 1 cities.

Zhonghai Yu - *China International Capital Corporation Limited, Research Division - Associate*

I have follow-up questions. So given that we have very strong capability in terms of teacher recruiting and training and management, when would you see will be the best timing for us to move from Philippine teachers to like European and Western American teachers? I know we did have -- stop our American Academy business, but when will be the best time for we to get back into the game?

Min Xu - *China Online Education Group - CFO*

(foreign language)

Jiajia Huang - *China Online Education Group - Founder, Chairman & CEO*

Okay. (foreign language)

Min Xu - *China Online Education Group - CFO*

[Interpreted] Yes, okay. So as we mentioned earlier, one of our core competencies is our teacher management. So in the Philippines, we have 1,000-plus full-time team working with close to 20,000 Filipino teachers. We have -- we also have 8 local offices in the Philippines. We're very proud of the teaching quality of our Filipino teachers. And we firmly believe that a key for English study is the frequency, how frequency you take the -- you take your lessons, not where your teachers are from. And we are also very lucky that we are getting support from the government of both China and the Philippines and under the One Road One Belt policy, and we believe that there is a lot of opportunities for us to continue to build up our core competencies in the Filipino teacher operation.

Jiajia Huang - *China Online Education Group - Founder, Chairman & CEO*

(foreign language)

Min Xu - *China Online Education Group - CFO*

[Interpreted] And we believe our focus on the lower- tier city has been quite successful, and we will stick to that.

Operator

(Operator Instructions) The next question comes from Roger Parodi of Silverhorn.

Roger Parodi - Silverhorn Principal Investors; Managing Partner

Actually, you have -- actually, I have already discussed with you what I want -- the main questions I wanted to ask. But you might still give some color. You were able to decrease the loss very substantially. What was the main reason you could do that?

The other thing, your -- now 73% come from second and -- the low-tier cities, not first-tier cities. What's -- how could you achieve that? Because I think it takes quite a different marketing approach and does that led to -- that you could decrease the loss. And then you were saying -- you had a very impressive margin as well, the gross margin. What is the reason for that?

Jiajia Huang - *China Online Education Group - Founder, Chairman & CEO*

(foreign language)

Min Xu - *China Online Education Group - CFO*

[Interpreted] Okay. I'll translate first. So let me share why the net loss narrowed down this quarter. So the first important reason I want to talk about is about the gross billing P&L breakeven. So starting 2Q '18, our one-on-one business has achieved gross billing P&L breakeven for 4 consecutive quarters. We explained in earlier earnings call what is gross billing P&L contribution. So basically what we does is that we take the gross billing times the gross margin and then subtract sales, marketing, G&A and R&D to get our gross billing P&L contribution. So because the revenues are deferred until the lessons are taken, so we should see positive impact from previous positive gross billing P&L contribution starting this year.

Jiajia Huang - *China Online Education Group - Founder, Chairman & CEO*

(foreign language)

Min Xu - *China Online Education Group - CFO*

[Interpreted] All right. So next, I'm going to talk about gross margin, which you also asked about. So there are several fronts we're getting some improvement. So number one, our -- we did a price increase earlier in 2019. We increased price by 10% to 15%. So this contributed to our one-on-one business margin increase.

Second, because our American Academy business has relatively lower margin, we actually are seeing a lower mix of our American Academy in Q1. So that also contributed to some of the gross margin improvement.

And third, our small class business also improved its margin from last quarter's 27.9% to this quarter's 45.7%. So all these contributed to our margin expansion.

Jiajia Huang - *China Online Education Group - Founder, Chairman & CEO*

(foreign language)

Min Xu - *China Online Education Group - CFO*

[Interpreted] Last but not least is the sales efficiency. As we mentioned earlier, we actually improved our non-GAAP sales and marketing expense as a percentage of our gross billing from Q1 last year's 48% to 39% in this quarter. So all these factors contributed to our margin expansion, and we will continue to work very hard on all these fronts to target to continue to decrease our net loss.

Roger Parodi - Silverhorn Principal Investors; Managing Partner

Okay. Understood. Do you still hear me, Xu Min?

Min Xu - *China Online Education Group - CFO*

Yes.

Roger Parodi - Silverhorn Principal Investors; Managing Partner

Okay. Maybe you'll allow me to have a quick follow-on question that's related to the guidance for Q2. Looking at all these impressive operational improvements, what is the normal growth rate that we could -- now that you would see that, that still allows you to -- I know it's a very theoretical question, I will leave it up to you how to answer it. But at what growth rate do you think you can maintain such an operational improvement, such a efficiency improvement than can continue to grow? When I just look at this number right now for Q2, it's probably a bit on the softer side. Just to give me a bit more confidence that the growth engine is still working.

Min Xu - *China Online Education Group - CFO*

Yes. So in terms of the expectation of the growth, I would say in the near term, we believe the growth will be, especially the one-on-one growth, we should be expecting a similar growth rate to probably last Q2, Q3. And because as we mentioned earlier, we're not putting a lot of emphasis on the gross billing growth. So as long as we're probably achieving similar one-on-one business growth as last year, our emphasis is still on -- continue to decrease our net-net loss.

Jiajia Huang - *China Online Education Group - Founder, Chairman & CEO*

(foreign language)

Min Xu - *China Online Education Group - CFO*

[Interpreted] All right. So let me translate. So when we look at our Q2 guidance, it looks less impressive just because we did really great in Q1. And the growth in Q1 looks even better when you remember that we had a really weak Q1 in 2018. So -- but we do expect our one-on-one business to continue to grow. And especially when you look at year-over-year growth, it is still much stronger than a year ago.

And also for the small class business, we're also seeing a decline. And after 1 year's operation, we do see small class as a great product and -- but it is still looking for its targeted customer segment. So what we see is that the customer acquisition cost for small class business is still higher than our one-on-one business, very similar to other small class peers. So it is our target to continue work on the business model to lower our customer acquisition costs and improve the unit economic model. And as you see that as we continue to balance our business model, trying to achieve getting closer to profitability, we will continue to target to grow our business in a healthy way.

Operator

As there are no further questions now, I'd like to turn the call back over to the company for closing remarks.

Judy Piao - *China Online Education Group - Head of IR*

Thank you once again for joining us today. If you have further questions, please feel free to contact 51Talk's Investor Relations through the contact information provided on our website or the Piacente Group investor relations. This concludes this conference call. You may now disconnect your line. Thank you.

Operator

Once again, the conference has ended. You may disconnect your line. Thank you.
