THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

TAL - Q2 2020 TAL Education Group Earnings Call

EVENT DATE/TIME: OCTOBER 24, 2019 / 12:00PM GMT

THOMSON REUTERS

CORPORATE PARTICIPANTS

Echo Yan *TAL Education Group - Head of IR*

Linda He *TAL Education Group - VP of Finance*

Rong Luo *TAL Education Group - CFO*

CONFERENCE CALL PARTICIPANTS

Alex Xie *Crédit Suisse AG, Research Division - Analyst*

Felix Liu *UBS Investment Bank, Research Division - Research Analyst*

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

Mark Li *Citigroup Inc, Research Division - Director*

Sheng Zhong *Morgan Stanley, Research Division - Associate*

Yuzhong Gao *China International Capital Corporation Limited, Research Division - Analyst*

Zhangxiang Liu *China Renaissance Securities (US) Inc., Research Division - VP*

PRESENTATION

Operator

Thank you, ladies and gentlemen. Thank you for standing by, and welcome to the TAL Education Group Second Fiscal Quarter 2020 Earnings Conference Call.

(Operator Instructions)

Please be advised that today's conference is being recorded.

I would now like to hand the conference over to your first speaker for today, Ms. Echo Yan. Thank you. Please go ahead, ma'am.

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

Thanks, operator. Thank you all for joining us today for TAL Education Group's Second Fiscal Quarter 2020 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; Linda He, Vice President of Finance; and myself, IR of TAL. Following the 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 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, please.

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 earning call. Our second quarter revenue performance was based on the robust and healthy growth of our overall small class business in the cities we currently cover and the continuous scaling of our online courses.

Net revenue growth in the second quarter was 33.8% year-over-year in U.S. dollar terms to USD 936.6 million and a 38.7% in RMB terms. Total normal priced long-term course Student Enrollments increased by 54.5% year-over-year, most driven by both the growth in online enrollments as well as the Xueersi Peiyou small class.

GAAP income from operations decreased by 13.5% to USD 69.9 million in the second quarter. Non-GAAP income from operations was almost flat to USD 98.8 million. The rise in operating expenses incurred in Q2 was mainly due to increased sales and marketing spending for research and development spending and in online initiatives.

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 second quarter. Next, Echo Yan, our IR Director, will review the second quarter financials. After that, I'll update you on our key strategy execution and discuss our business outlook next quarter. Linda, please.

Linda He - *TAL Education Group - VP of Finance*

Thanks, Rong. Fiscal second quarter revenue was based on solid growth momentum in the various education services of our tutoring business. Let me review the business by different revenue streams.

Let me start with small class and other business, which consists of Xueersi Peiyou small class, Firstleap, Mobby and some other educations programs and services. These accounted for 76% of total net revenue compared to 81% in the second quarter last year. The revenue growth rate was 25% in U.S. dollar terms and 30% in RMB terms.

Xueersi Peiyou small class, which remains our stable core business, represented 63% of total net revenue compared to 70% in the same year ago period. The lower revenue contribution from Xueersi Peiyou was mostly due to the faster growth of xueersi.com online courses, which accounted for 16% of total revenue in the quarter compared to 12% in the same period last year. Net revenue from Xueersi Peiyou small class was up by 20% in U.S. dollar terms and 24% in RMB terms, while our normal price long-term course enrollments increased by 27% year-over-year. This growth rate reflects the solid growth of both Xueersi Peiyou off-line and online class.

Peiyou off-line small class revenue increased by a healthy rate of 12% in U.S. dollar terms and 16% in RMB terms, while off-line normal price long-term course enrollments increased by 12% year-over-year. With Peiyou online, as you know, we offer the online courses with localized contents as complementary service to Peiyou online in more and more major cities of our network. Peiyou online offers regular and short-term courses and other promotion courses. In the second quarter of fiscal year 2020, which is this fiscal year, Peiyou online accounted for approximately 11% of total Xueersi Peiyou small class revenue and 28% of total Xueersi Peiyou normal priced long-term small class enrollments. In the second quarter of fiscal year 2019, which is last fiscal year, revenue and the normal priced long-term enrollments from Peiyou online were 5% and 9%, respectively, of total Xueersi Peiyou small class business.

We continue to enjoy a stable growth performance across the board of the cities we currently cover. Xueersi Peiyou small class revenue from the top 5 cities, which are Beijing, Shanghai, Guangzhou, Shenzhen and Nanjing, grew by 15% year-over-year in U.S. dollar terms and accounted for 54% of Xueersi Peiyou small class business. Revenue generated from cities other than the top 5 grew by 26% in U.S. dollar terms, and the other cities accounted for the remaining 46% of the Xueersi Peiyou small class business. The drivers of this widely spread growth are solid market demand across all cities, incremental ramp-up of enrollments from our earlier classroom expansion as well as our ongoing efforts to improve operational efficiency.

We continue to enrich our course offerings with a growing number of off-line and online courses in curricular and extracurricular subjects. As always, we believe that the quality, fullness and relevance of content are at the basis of our business. We have successfully expanded our curriculum with Chinese and English courses. By the end of August 2019, we have offered Xueersi Peiyou Chinese classes in 25 cities and English classes in 29 cities. Furthermore, Firstleap, Mobby and a few other education programs all grew at a steady pace, both in revenues and enrollments in the second fiscal quarter. We expect that these diversified courses will gradually contribute more to our overall business.

Next, I'd like to briefly discuss our Zhikang one-on-one business. This business sector has a strong second quarter and achieved year-over-year revenue growth of 40% in U.S. dollar terms and 46% in RMB terms. Zhikang one-on-one accounted for approximately 8% of total revenue compared to 7% in the second quarter of fiscal year 2019.

Let me update you on our capacity expansion. As always, we pursue well-paced off-line capacity growth. At the same time, we invest in new technology and online business to further improve our overall operational efficiency and closely follow all the standards and regulations. We added a net 30 learning centers, of which 24 were Peiyou small class learning centers, 4 Firstleap centers and 2 one-on-one centers. During the quarter, we added 300 Peiyou small class classrooms.

Meanwhile, we continue to enter new cities according to our strategic and operational planning. In the second quarter, we entered into 12 new locations with a dual-teacher small class learning center in each. Our geographic coverage currently amounts to 69 cities across China. The new cities are Jining, Taian, Yancheng, Suqian, Taizhou, Jinhua, Quanzhou, Taizhou, Jiaxing, Zaozhuang, Lianyungang and Zhangzhou.

Overall, by the end of August, we had 758 learning centers in these 69 cities, of which 538 were Peiyou small class, 17 were Mobby small class, 86 were Firstleap small class, 114 were Zhikang one-on-one and 3 were Xueersi International. As for the third quarter, till now, we have rented approximately 11 Peiyou small class learning centers, and we expect to add a few more and close down some learning centers based on standard operations. These estimates reflect our current expectation, which is subject to change.

Moving now to our online business. Second quarter revenue from xueersi.com grew by 88% in U.S. dollar terms year-over-year and 94% in RMB terms, where normal priced long-term courses enrollments grew by 134% year-over-year to about 1.4 million. Online contributed 16% of total revenues and 40% of total normal priced long-term enrollments this quarter compared to 12% of total revenue and 26% of total normal priced long-term course enrollments in the same year ago period, respectively. The rapid growth in online business was supported by dedicated sales and marketing efforts, retentions of the previous quarters as well as the growing demand for online education.

With that, I will now turn the call over to Echo Yan for the update on second fiscal quarter financial results. Echo, please.

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

Thanks, Linda. Let me now go through some key financial points for the second quarter of fiscal year 2020. The breakdown of ASP for the various businesses is as follows: normal priced long-term Xueersi Peiyou small class ASP decreased by 3% in RMB and 6% in U.S. dollar year-over-year; Peiyou off-line normal priced long-term courses ASP increased by a low single-digit percentage in RMB terms year-over-year; normal priced long-term Zhikang one-on-one courses ASP increased by 10% in RMB and increased by 5% in U.S. dollar terms year-over-year; normal priced long-term online courses ASP decreased by 10% in RMB and 13% in U.S. dollar terms year-over-year, mainly due to the mix change of larger proportion of high school enrollments. High school long-term online courses ASP is relatively lower than overall average long-term courses ASP.

Gross profit increased by 39.9% to USD 517.8 million from USD 370.2 million in the same year ago period. Gross margin for the second quarter improved to 55.3% as compared to 52.9% for the same period of last year.

Selling and marketing expenses increased by 73.5% to USD 263.3 million from USD 151.7 million in the second quarter of fiscal year 2019. Non-GAAP selling and marketing expenses, which excluded share-based compensation expenses, increased by 73.4% to USD 258.9 million from USD 149.3 million in the same year ago period. The increase of selling and marketing expenses in the second quarter of fiscal year 2020 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 great number of programs and services offerings compared to the same period in the last year.

Operating income decreased by 13.5% year-over-year to 30 -- to USD 69.9 million. Non-GAAP operating income decreased by 0.2% to USD 98.8 million. Other expense was USD 55.6 million for the second quarter of fiscal year 2020, mainly related to loss from fair value change of an equity security with readily determinable fair value. Impairment loss on long-term investments was USD 54.2 million for the second quarter of fiscal year 2020 compared to nil for the same period in the prior year. Impairment loss on long-term investments was mainly due to other-than-temporary declines in the value of long-term investments in several investees.

Income tax benefit was USD 8.1 million in the second quarter of fiscal year 2020 compared to USD 15.5 million of tax -- income tax expenses in the second quarter of fiscal year 2019. Net loss attributable to TAL was USD 14.4 million in the second quarter of fiscal year 2020 compared to net income attributable to TAL of USD 77 million in the second quarter of fiscal year 2019.

Non-GAAP net income attributable to TAL, which excluded share-based compensation expenses, decreased by 84.8% to USD 14.5 million from USD 95.1 million in the same year ago period.

Basic and diluted net income per ADS were both USD 0.02 in the second quarter of fiscal year 2020. Non-GAAP basic and diluted net income per ADS, which excluded share-based compensation expenses, were both USD 0.02.

From the balance sheet, as of August 31, 2019, the company had USD 1,542.3 million of cash, cash equivalents and short-term investments compared to USD 1,515.6 million of cash, cash equivalents and short-term investments as of February 28, 2019. As of August 31, 2019, our deferred revenue balance was USD 497.6 million compared to USD 869.8 million as of August 31, 2018, representing a year-over-year decrease of 42.8%, mainly due to the change of tuition fee collection schedule to meet certain regulatory requirements.

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

Rong Luo - *TAL Education Group - CFO*

Thank you, Echo. In this fiscal year, we are in the midst of the further transitioning our base model to a multi-pronged education service model. This diversified model includes our off-line learning center and geography network, online business and various other education programs and projects, such as our smart education solutions and open-platform business. I would like to update you on each business model.

Our core Peiyou small class business remains healthy and stable. In Q2, we have entered into another 12 new cities. And including the 1 new cities we entered in Q1, we have covered 13 new cities in the first half of fiscal year 2020. Till now, Peiyou off-line has around 13,000 classrooms and a network of nearly 70 cities in China. Together with the fast growth of Peiyou online and our ongoing efforts to improve our operational efficiency, the profitability of Peiyou was slightly improved in Q2 as well.

Looking ahead, we expect the growth momentum of Peiyou small class to continue as we further develop our off-line network at a reasonable speed and scale the business. We keep seeking to operate and scale our Peiyou business by leveraging our off-line and online advantages and resources and, as always, with long-term sustainability in mind.

Our online business is a high-growth, early-stage business, which also faces intense competition and ever-changing market dynamics. As one of the pioneers in this sector, we are very confident about the huge potential of online education. We strongly recognize the social value and the market opportunities of online education, hence our ongoing explorations and developments in this area.

As an education product and service provider, we will never just go after a high-revenue growth base only, but more importantly, the fast growth rate should be achieved in a healthy and sustainable way. We will spend more efforts to further pursue a superior online business model that brings the students and the parents lasting satisfactory experiences and learning outcomes. We will continuously invest to innovate our products, technology and operational efficiency with full attention to the necessary details.

Now a brief update on smart education solutions and open-platform business. Till the end of Q2 fiscal 2020, mainly in the lower-tier cities and geographical areas, we have cooperated with a growing number of public schools with our smart education solutions. We also worked with less than 2,000 small- and medium-sized education institutions through different service level in our open-platform business. Both smart education solutions and open-platform business are still small-scale and in an early development stage.

But as we mentioned before, by leveraging our vast educational resources in these ways, we continue to seek diversified development opportunities and contribute to the overall education sectors innovation and optimizations. As we gradually reach more and more lower cities and more and more lower-tier local areas, a large -- a larger portion of our young people will have more options to enjoy equal and improved educational resources with easy access and at affordable cost.

Turning finally to our business outlook. Based on our current estimates, total net revenues for the third quarter of fiscal year 2020 are expected to be between [USD 862.6 million] and USD 843.8 million (sic-see press release "USD 826.6 million and USD 843.8 million"), representing an increase of 41% to 44% on a year-over-year basis. If not taking into consideration the impact of potential change in exchange rate between RMB and U.S. dollar, the projected revenue growth rate is expected to be in the range of 45% to 48% for the third quarter of fiscal year 2020.

That concludes my prepared remarks. Operator, we are now ready to take questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) We have our first question coming from the line of Alex Xie of Crédit Suisse.

Alex Xie - *Crédit Suisse AG, Research Division - Analyst*

Congratulations on a very strong set of results. So I would like to ask about our strategy for this Peiyou business. We have already introduced, I think, Peiyou online to more and more cities. And now in this quarter, it seems that we are also accelerating a little bit for the small class -- a number of small class rooms. So what are expectations for the full year of future capacity expansion? And what are our strategies to faster integrate online and off-line of Peiyou business?

Rong Luo - *TAL Education Group - CFO*

Thank you, Alex. Yes, that's a very good question. I think the right before we answer this question, we need to go back to see what happened in the past 2 years, and especially last year July earning call, we have highlighted risk of the policy to the Street, and I think which definitely has impact our operations in the past, maybe 6 quarters. With the new policies --a lot of new policies in place, the regulation become more stricter, much stricter than before. The pressure of being compliant is also getting bigger than before. And on the other side, internally, frankly speaking, if you can go back to see our past 5 years' growth, in several years, we grow very fast, more than 50%, even 80% capacity growth.

So I think the policies were a good timing for us to review our business models and be more cautious. So in the past 1 or 2 years, you probably can see -- so we made a lot of efforts how to improve our product experiences, how to improve our whole systems operating efficiency and how to improve our status -- healthy status. We have different KPIs. How to make sure our operation can be more compliant than before, which takes us [a slip] on time. And as a result, you probably can see that we slowed down the off-line revenue growth in the past, maybe 6 quarters.

And at the same time, we're also spending a lot of efforts to develop the Peiyou online strategy and the Peiyou online products. And that is not only newly addition of a new product but also kind of experience to change the learning process and the learning experience for our students. So after several quarters, we -- today, we make a little bit progress in off-line business perspective. So not only including the curriculums, the products, the students and kind of interactions, we probably can see that all these efforts pay off, and we're seeing our key KPIs is also improving.

For example, you probably can see that in our seats fulfillment rate, our retention rate and our refund rate all of them have some low single-digit improvement, which is a very good indicator showing we have managed our business, improved the products and made things work even better.

So starting from almost last year -- sorry, last quarter, we decided to gradually accelerate a little bit of the off-line learning center expansion pace. And all of these, you probably can also see that in this quarter, we added 12 new cities. All of them is using the dual-teacher models. That is based on all of our kinds of development and investment in the past on online technology and make us easier to be scalable to more cities in a much bigger way.

So -- and looking forward, I think in the coming a few quarters, we are continuing to be very cautious, but with improvement in our management efficiencies and all -- and our Peiyou online-kind-of new technologies, and all of them, we will gradually accelerate a little bit in the off-line expansion pace, and which is a very good way for us to contribute to the whole company's total revenue and profitability.

For the Peiyou online, some special numbers I need to draw your attention, I think in Q2, we grow our Peiyou online revenue by 192%. And in Q1, we grow around 165%. The percentage -- the revenue percentage of Peiyou online versus total Peiyou revenue is around 11% versus last year's only 5%. And the enrollment, around 20% versus last year is only 9%. So looking forward, we will continue to accelerate a little bit and to adding more learning centers and more classrooms into our network, we will use our Peiyou online technologies to empower more offline students, to give them or -- much experiences.

You probably can see in Q3 and Q4, we will have more Learning centers added to the network, and which is a very important change because we spend 1 or 2 years to do a lot of kind of products, new innovations. And now we decided to accelerate a little bit. By it doesn't mean we can go back to the high-growth stage as what you can see in the past 3 or 5 years, so we will still be very cautious with the approval policy as first priority to make sure our all off-line centers can be more compliant. And we will be very careful about the curriculums, and we'll also be very careful on how to use our online technologies to empower the off-line students.

So that's the general strategy for us. And by the way, even when you see our adding new learning centers, the contribution will not come out very soon. It takes them around several quarters to get into effect. So maybe next year, in the spring, or next year summer will be the best time to do that. So that's the general strategy for us to -- about the Peiyou business, both online and off-line. Thank you, Alex.

Operator

The next question is from the line of Yuzhong Gao of CICC.

Yuzhong Gao - *China International Capital Corporation Limited, Research Division - Analyst*

Congrats on solid results. So our question focused on your online business. (foreign language) So currently, clearly, we have seen intensified competition in the past summer, and there seems to be a deceleration this quarter. So could you maybe share your thoughts on the latest competitive landscape and over online revenue growth trajectory in both the near term and long term as well as margin outlook?

Rong Luo - *TAL Education Group - CFO*

Okay. I think the Xueersi online school business is growing on track in Q1, Q2. As in Q1, they grow revenue growth [122%] and gross margin [121%]. In Q2, they grow 94% revenue and 154% in enrollment.

I think now is a right timing for us to go back to see what happened in the past 2 quarters. In the very beginning, as I mentioned, in last earning call, actually, we are not prepared for this work. So we are a little bit behind the other players in this market. The good thing is team quickly react -- and we improved a lot, especially in operations perspective -- we do a lot of adjustments and efforts. So we try to catch up. And the final result looks good, but we also want to give you more color about that. In the front perspective, I think how to reduce the cost to acquire 1 new customer actually is always a tough challenge to us. And we are now a company who is more experienced in marketing and sales. And we have some know-how last year, but this year, as more players coming into the battle field, actually, we have more lessons to learn. And we are a little bit behind at the beginning, but we finally catch up. So -- but this is a very good kind of turnover, which give the team so much confidence, they could do even better than today.

On the other side, we're also a little bit lucky is because education is a very kind of operation intensive industry and have -- when their -- when you attract the students come to watch the online classes, that's not over, that's only the beginning. So in the coming maybe few terms, the whole education system and the management system will work. We need to make sure that students feel happy and feel they learned something, and they feel satisfactory about the result of the learning. And then they will decide if they will try to retain or not. So this require a lot of efforts and operational perspective.

We're a little bit lucky because we were running in these models in the past, maybe more than 10 years, as education company. So we have some know-how, better than other people. But when you're faced with this kind of huge volume of students actually, we also have a lot of details we need to improve. In the last few weeks, our senior management and our CEO is also to be their teacher assistance in some -- certain class. So during all of this practice where we'll also figure out a lot of challenges and a lot of details and problems in our system.

So even if only in numbers of perspective, if only in the enrollment perspective, it looks good, but still we have big potential we can improve.

And on the other side, as -- I think as an education product and service providers, we will never just go after a high revenue growth or we will never only go after for a crazy revenue growth. And same as well we run our off-line business. More importantly, the growth rate must be achieved in a healthy and sustainable way, healthy and sustainable way. So we are seeking more and more market share as early as possible in the online education area, but this doesn't mean we will lost our money to do this.

So looking forward, I think online, we still strongly believe that is the model, and that is the new technology can change the landscape of this marketing. On the other side is our ways -- these 2 quarters' experiences, especially in the summer, and we have a lot of lessons learned. And we need to be more balanced, and we need to improve our operational efficiency. And looking forward, we'll continue to leverage the online offer to attract more students, get more market share, have more enrollment. And at the same time, we'll continue to [improve] the product quality and the product experiences and the satisfaction from students and the parents as the key for everything, especially in education sectors.

So looking into the coming quarters of online, we probably can see our enrollment growth continue to be quite healthy, but our revenue growth may be a little bit lower than in the enrollment growth in the coming quarter, is because the contribution -- the mix -- the more enrollments today, the -- we'll have higher mix from the students in senior high school compared to last year, while the senior high school, the students ASP is lower than the primary school students. All of these numbers is only 1 quarter's numbers. I think we talk about online, we need to be at least -- build these sectors in 3 years' time. So we still strongly believe in these potentials, and we will continue to improve our investments in the research and development side and the technology and product side to make sure we have much more product portfolios to offer the students, we can have much more optimized cost structure products to support more people. So that's our key strategy looking forward.

Operator

Our next question is from the line of Mark Li of Citi.

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

Congratulations on the very strong results. I want to ask for our next quarter, I think the revenue guidance is around 5% ahead of consensus expectation. So can we know what is the bigger factor to beat for online or off-line? And also, the -- we appreciate any color on the selling and marketing expenditure color for the future quarters.

Rong Luo - *TAL Education Group - CFO*

Thank you, Mark. In the first place, I actually have no idea what is the consensus for the online or off-line revenue growth separately. So in our coming perspective, we only give what revenue guidance in the group level. I think something -- if we compare quarter-over-quarter, in Q3 compared to Q2, I think Q2 will grow around 38%. And Q3, our guidance is 45% to 48%. I think most -- the biggest difference is coming from Peiyou small class business. We are seeing their growth rate is, in Q3, is higher than Q2. We're also seeing Peiyou online is also fast growing in the first 1 or 2 quarters. Actually, they are close to 200% revenue growth, and we can foresee this high growth will continue in the coming quarters.

And Xueersi online school is also growing on track as what we expected. But considering their high growth in the first quarter and the second quarter, so we don't see any huge differences quarter-over-quarter. And the most important kind of contributor are coming from the Peiyou core busines.

Well, on the sales and marketing. I think probably you can see, in the summer, we're running an online campaign. And in Q3, in fall-term, we're also running online promotion campaigns for the fall. And compared to last year, the same quarter, same Q3 last year, actually, we don't run that much. So this quarter's sales and marketing for online in Q3 is higher than last -- than the same quarter last year. So -- which will give us some kind of pressures in margin status in Q3. but if we put everything in 1 year's view, you probably can see that this year, the online will be loss-making position, but we're slightly loss-making position but we don't foresee any huge loss over there. And since we still have 1 quarter to go, especially in Q4. So -- but based on what I know today, we don't see any huge surprise we need to give hands-up to you guys. And running a online business is not easy. Maybe nothing is easy when aiming a high target. So we will make sure both online and off-line growth can be in a healthy and sustainable way. That's our key priority. Thanks, Mark.

Operator

Our next question is from the line of Sheng Zhong of Morgan Stanley.

Sheng Zhong - *Morgan Stanley, Research Division - Associate*

Rong, you mentioned a lot about regulation at the beginning of this call. So can you give us some more update on the regulation now? And whether it will impact your off-line and online both, going forward?

And secondly, I want to ask -- have a follow-up on the online business. Can you give us some breakdown on the online students from Tier 1, Tier 2 city and lower-tier city? And then what's your strategy to go to lower-tier city?

Rong Luo - *TAL Education Group - CFO*

Okay, Zhong Sheng. I think for the regulations, the off-line regulations is almost in place for more than 1 year. So frankly speaking, our company has experienced tough time how to see of this kind of new policy and regulations now. So I can't say today that's perfect, but compared to 1 or 2 years ago, we're making better than before. And for the online regulations, I will leave to Linda to give you more information about that because the government just launched a new policy a few weeks ago.

Linda He - *TAL Education Group - VP of Finance*

Yes. On September 30, together with other 10-related departments, China Ministry of Education issued a document regarding important general guidance of a healthily developed online education industry in China. The document continuously illustrated and provided the policy level of the support to China online education next step and long term development. As one of the leading online education pioneers, we are very happy to see and even welcome the online education regulations as always, and we will do our best to support and work with the whole industry and government to keep improving the online education product, technologies and services. And we believe that with the government's support, technology developments and industry efforts, the online education will benefit more and more students, especially the kids who are based in lower-tier geographic areas.

And finally, I'd like to emphasize again that we welcome and fully support all these regulations and policies, which will have improved the standards and services of the industry and further strengthen the overall industry environment.

Rong Luo - *TAL Education Group - CFO*

Yes. And you asked the second question about our strategy on the low-tier market for the online offering. I think that's one of the best questions. And I have to say, by the end of today, I think the enrollments coming from lower-tier cities, actually, or the enrollments coming from the places we don't have Xueersi Peiyou networks, actually, I think the contribution is still below 20%. And part of the reason is

because of online offerings can be accepted, actually, which is more popular in the high-tier -- in the Tier 1, Tier 2 because it's a place we are there -- we have a huge presence, we have brand names, we have everything and the students -- and the student/parents in the Tier 1, Tier 2 cities -- places, they have seen a lot of online offerings before. So it's much easier for them to buy these offers. And they also know our name. So sometimes, that's kind of low-hanging fruit, so that's part of the reason why in the past, we have focused a lot of things over here. And if in the profitability perspective, maybe most of the profits also coming from the top cities based on our experience in the Peiyou off-line business network.

But looking forward, definitely, we need to find a more effective way how to penetrate in the Tier 3 and Tier 4, even much lower-tier cities now. I can't say I find a perfect way. I know, in the past few months, some of our investors give us very good suggestions and also pilot some of the suggestions in some selective cities. Based on the small pilots we run today, some of them is making progress, some of them doesn't work. So these become very important topic for us, how we can penetrate the lower-tier cities in the coming few years. We can't rely on at the same way of doing online marketing to penetrate the low-tier cities so we need much creative and innovative ways to do so. I don't have perfect answers now, and we are still doing a lot of pilot now. But what we can say is in the Tier 1 and Tier 2 -- in the top cities which we have presence, and are making first progress now and we will continue to re-enhance our competitive advantages. For the lower-tier geographies, we don't want to hurry to reach a conclusion. Sometimes, the hurried conclusion means a mistake. And so we continue to try. And even our senior management, we spend a lot of time over there. We're also very open to see what is doing good in other industry, and in other sectors. We're also very open to hear all the investors and all their friends who have some new ideas. Feel free to -- please feel free to let us know. We will figure all the best way to do that, and both we can balance the cost of new customer acquisition and the profitability of the lifetime value. So we'll keep you guys posted if we're making any more progress. Thank you.

Operator

Next in line is Alex Liu of China Renaissance.

Zhangxiang Liu - *China Renaissance Securities (US) Inc., Research Division - VP*

Just on a really high level, we know there's a lot of new players coming to the market for online business. Whether this mean -- just want to hear your thoughts on this -- whether this means the entry barrier of the [tiering] business is lowered [compared to] before simply because we have the online model already. And if this is the case, should we think about, going forward, the company in general will be conducting the acquisition every single years going forward?

Rong Luo - *TAL Education Group - CFO*

Okay. Thank you for the question. I think in the first place, let's compare to numbers. For the off-line education companies in China, I think more than 0.5 million more or less, while the online players in this market, you probably know a lot of names, but below 100. So 0.5 million compared to 100 -- we probably can see actually the competition -- the entry barrier actually is quite different from before.

In the second place, if we're only simply running the online model through -- like forecasting and pre recording combined model, which means the model itself has very low entry barriers. So online education doesn't mean we'll use the Internet or we'll use the technologies to move the off-line classrooms to online, and that's it. That's maybe not the case. I think that's a huge kind of revolution, not only impact the classroom, but also impact the whole learning process. For example, how the students do the pre studies? And how the students -- they can answer their questions? And how students finish their homework? How the students can -- based on statistics of data through their learnings, and then find the right way to do so? So I think the problem for online today is, the online model today, we need to continue to invest and continue to develop, to make sure the online the model itself has more kind of entry barriers compared to the other one. And we're sure that will happen because if you do the interviews to the students, you probably can see that most students and the parents, they are willing or they are eager to know more information, more data for themselves and find the most effective way. They can spend fewer time -- less time but they have much bigger outcome. This will lead to kind of the intelligent learning in the future, which has a lot of -- kind of the tech -- both technical and operational kind of challenges on us.

So if we are sitting here, we do nothing, we don't do investments and we just use this so-called okay-to-go models to try to replicate the whole country, I think that's not the right thing to do. The competition will be even more fierce because you guys are now making progress. So we are very -- fully aware of the challenges, but not only from competition, but also from the students and the teachers and the parents. Based on their feedback, we know our -- most of the online product today, even they are okay to use, but they are not perfect. So we need to continue investing R&D studies to make our products even more effective.

And I think competition, again, we don't believe that competition today is the most important problem to ask because the online penetration rate versus total students, even today, is very low. Even online growth is faster, but penetration rate is quite low. So what we need to struggle with, actually, is -- it's the gradually -- the market is being mature gradually. If you look into the primary school and the middle school and the senior high school, you probably can see that, I think the penetration rate of the primary school may be higher than the penetration rates in the middle school and in the senior high schools. When the students, especially the [iPad generation] students, when they grow up from primary school to middle school, from middle school to senior high, the penetration rate will be higher and higher. And on the other side is -- we don't think that online education is a winner takes all market. We believe if every players doing a lot of good things, in the end, across the market, we -- probably, we can see multiple players play in these markets. In the student perspective, the multiple players can offer you guys the best experiences and much competitive -- and a much affordable price. I think that's good, very good to the students and parents. And so today, we view most of the problems within ourselves first, most challenges and most mistakes we made is because of ourselves, it's not because of competition. So we will make sure our -- all of our leaders and all of our people can be highly connected to the students, help the students and being their teachers, being their friends, to know what is their pain points. I think that is the direction we have to go -- how we can use our investment and technology to remove their problems and improve their efficiency, I think that's the direction to go. Thank you.

Operator

Yes, We have open the line of Lucy Yu from Bank of America.

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

I got 2 questions. Firstly, could you please share with us about, like, conversion rate and the retention rate for the summer online promotional class and the normal class? That's first question.

And secondly, on the third quarter guidance, Rong, you mentioned that Peiyou small class will accelerate. How much of that is attributable to class scheduling shift? Because I recall last year, third quarter, some teacher takes 1-day off to sit down the exams so actually, part of the revenue in the third quarter was shifted. So any low-base impact? If we excluding that impact, will Peiyou small class still accelerating?

Rong Luo - *TAL Education Group - CFO*

Yes. In the first place, thank you so much for your remarkable memory. I think this year, compared to last year, yes, we have 1 weekend advantage because last year, they have to take exams. So I think one week is around 3% to 5% of the total revenue for this fiscal year. And if we compare to the total revenue growth, you probably can see that in Q2, the Peiyou revenue growth is around 25%, 23% to 25%. But even we take this 3% to 5% out from Q3, the Q3 Peiyou growth is still higher, significantly higher than Q2. So that's the case, what we're going to show today.

And your first question about the conversion rate and the retention rate. I think conversion rate, you specify about online conversion rates. What we can say is that online conversion rates this year compared to last year is in a very similar level. The retention rate of online -- Xueersi online school is low single-digit improvement compared to last year. So that's the kind of the information we can share with you, guys.

Operator

Our next question is from the line of Felix Liu of UBS.

Felix Liu - *UBS Investment Bank, Research Division - Research Analyst*

Congratulations on the very strong results. I just want to come back to the summer promotion. We -- our summer marketing investment increased a lot. So I just want to ask, how do you think about the efficiency? Say, on a scale of 1 to 10, how do you rate your summer promotion campaign? And coming into the next quarter, if we compare on a Q-on-Q basis, how will the Q3 and Q4 marketing dollar or marketing budget be?

Rong Luo - *TAL Education Group - CFO*

Thank you for your questions. And I think it's too difficult to rate 1 to 10 about the performance of summer promotions, especially in our company. We never read that. But what I can say is in the group perspective, I think we feel happy to see the team has tailored challenges and go through the challenge. You probably know that in the year beginnings, we have some -- we have some org change. So the team needed to take some time to fill in the new way and then they changed their old behavior into a new behavior, which is focused more on product and the students. So -- but during this time, the -- some of other players, actually, they do a lot of things and they have one or two months lead time compared to us. And so we feel very good. The team actually quickly react and go through the challenges. Even we're not doing perfect but the team is very good.

And on the other side, I think we don't see our conversion rate has some huge differences compared to last year. And sometimes, compared to other players, sometimes, our conversion rate is even lower, especially in the beginning of summer. So we need to -- probably the key reason is not because we invest too much money. The key reason is because when you invest in the front, you need to have a lot of things ready, especially in a supply chain perspective. So we need to have a very good way to improve the efficiency of our operation

in the back end.

So when you look into education business, that is not separated but combined a lot of details in the front end, middle end, and back ends. So if that can happen again, I think we have a chance. And we can have more time to prep -- to be fully prepared, I think we have more chance to do a better job than before. But even in today's case, we feel good about the -- the team had made a lot of progress compared to last year.

And looking forward to Q3 and Q4, I think Q3-- I think most of you guys probably have seen that, in WeChat moment, we invest certain money of their marketing dollars to attract new students, normal priced students for online school and -- which gives us some pressures in margin for the short term but will be beneficial in the long run. And Q4, we also reserve a certain level of marketing dollars prepare for that, but we need to evaluate or we need to look into other competition and the other market dynamics to decide if whether we will spend it or not. So we have made everything ready, but we haven't make the final decision yet. And we probably -- we'll let you guys know in the next quarter earnings call.

And -- but again, we don't think promotion, marketing money is the only way to grow a business. The key of growing our business is still go back to the product, go back to operational efficiency, go back to do a lot of detail in your dirty works. We need to be much closer to the students than before, and we need to make sure the whole team can react much quickly than before. So this -- we have a lot of lessons learned from summer and from fall. So we are happy the team is a fast learner. So we will continue to make this better and better, even not perfect, but we will try our best

Operator

Ladies and gentlemen, this concludes our Q&A session and our conference call for today. Thank you for participating. You may now all disconnect.