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TEDU - Q1 2017 Tarena International Inc Earnings Call

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Tarena International, Inc., First Quarter of Fiscal Year 2017 Earnings Conference Call. (Operator Instructions). Today's conference is being recorded. If you have any objections, you may disconnect at any time.

I would now like to turn the call over to your host for today's conference, Ms. Helen Song, Tarena's Investor Relations Director.

Helen Song

Thank you, operator. Hello, everyone, and welcome to Tarena's First Quarter 2017 Earnings Conference Call. The company's earnings results were released earlier today and are available on our IR website, ir.tedu.cn, as well as our Newswire services.

Today, you will hear opening remarks from Tarena's Founder, Chairman and CEO, Mr. Shaoyun Han; followed by our Chief Financial Officer, Dennis Yang, who will take you through the company's operational and financial results for the first quarter 2017 and give guidance for the second quarter and full year of 2017. After their prepared remarks, Mr. Han and Mr. Yang will be available to answer your questions.

Before we continue, please note that the discussion today will contain certain forward-looking statements made under the safe harbor provisions of the U.S. Private Securities Litigation Reform Act of 1995. These forward-looking statements are subject to risks and uncertainties that may cause actual results to differ materially from our current expectations. Tarena does not assume any obligation to update any forward-looking statements except as required under applicable law.

Also, please note that some of the information to be discussed includes non-GAAP financial measures as defined in Regulation G. The U.S. GAAP financial measures and information reconciling these non-GAAP financial measures to Tarena's financial results prepared in accordance with U.S. GAAP are included in Tarena's earnings release, which has been posted on the company's IR website at ir.tedu.cn.

Finally, as a reminder, this conference is being recorded. In addition, a webcast of this conference call is available on Tarena's Investor Relations website.

I will now turn the call over to Mr. Shaoyun Han, Tarena's Founder, Chairman and CEO. Mr. Han will speak in Mandarin, and Mr. Yang will translate.



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Shaoyun Han - *Tarena International, Inc. - Founder, Chairman of the Board and CEO*

(foreign language)

Yuduo Yang - *Tarena International, Inc. - CFO*

Thank you, Helen, and welcome, everyone, to our first quarter 2017 earnings conference call.

Shaoyun Han - *Tarena International, Inc. - Founder, Chairman of the Board and CEO*

(foreign language)

Yuduo Yang - *Tarena International, Inc. - CFO*

I'm very pleased to report that our net revenues in the first quarter increased by 23.5% to reach RMB 333 million, exceeding the high end of our previously issued guidance. This quarter, we're committed to positively invest in both professional education business and K-12 training programs through a number of new initiatives, such as standard network expansion and new courses; research and development will significantly increase our geographic coverage; total number of learning centers; as well as seat capacity, which laid a solid foundation from a full year growth outlook.

Shaoyun Han - *Tarena International, Inc. - Founder, Chairman of the Board and CEO*

(foreign language)

Yuduo Yang - *Tarena International, Inc. - CFO*

In the first quarter of 2017, total course enrollment increased by 16% year-over-year to reach 24,500. This is primary factor contributing to our net revenue growth in this quarter.

Our student enrollment number is more of a lead operational indicator that, defined as number of new students recruited and registered in the quarter, continue as healthy growth. Because of early timing of Chinese New Year, we took the favorable market opportunity and successfully achieved more than 20% year-over-year growth in student enrollment despite high base in the same period last year. Total student enrollment this quarter reached 27,785, which is the second-highest quarterly enrollment figure in Tarena's entire operational history.

Shaoyun Han - *Tarena International, Inc. - Founder, Chairman of the Board and CEO*

(foreign language)

Yuduo Yang - *Tarena International, Inc. - CFO*

This quarter, we continued to execute strategic and appropriate level strategy to further upgrade the curriculum portfolio and implemented differentiated advanced courses teaching model, which helped fully accomplish expected growth target in student enrollment. In meantime, we stay focused on collaborating with universities and enterprises to jointly explore professional education market opportunities.

On one hand, we've accelerated pace in cooperating with universities and colleges in China and have successfully established [62] joint major programs with universities and colleges in provinces such as Shandong, Inner Mongolia, Jiangsu and Jilin, et cetera.



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In January, Tarena win the award of enterprise-university cooperation partner issued by Ministry of Education in China. In addition, this April, we also signed a strategic cooperation agreement with Microsoft, who joined research and development -- research and develop professional education teaching content provides total solutions for higher education as well as [STEM] education for K-12.

Shaoyun Han - *Tarena International, Inc. - Founder, Chairman of the Board and CEO*

(foreign language)

Yuduo Yang - *Tarena International, Inc. - CFO*

Besides professional education business, our business initiatives in K-12 education under the name of Tongcheng, Tongmei and Tongchuang have shown solid progress towards our target. By the end of first quarter, the key education program has been rolled out in 15 cities. And in the quarter, we enrolled close to 1,000 students, which represents 304% year-over-year growth. Most of our students in K-12 education programs are recruited -- were taking courses through shared learning center facilities with professional education business. Our strategic adjustment in optimizing our cost content, operational model and organization structure for K-12 business in the past several quarters have been well implemented according to market demand, and we believe K-12 business will show robust growth momentum in the future.

Shaoyun Han - *Tarena International, Inc. - Founder, Chairman of the Board and CEO*

(foreign language)

Yuduo Yang - *Tarena International, Inc. - CFO*

This quarter, we've accelerated pace in opening new learning centers, better prepare for even greater growth potential in peak season for the business. Based on initiatives to expand standard network and optimize lease areas in existing learning centers, our total seat capacity jumped to 52,822 by the end of this quarter, up by 20% from the same period last year.

Shaoyun Han - *Tarena International, Inc. - Founder, Chairman of the Board and CEO*

(foreign language)

Yuduo Yang - *Tarena International, Inc. - CFO*

In term of professional education services, we opened 18 new learning centers this quarter on March 3. As a result, our total number of learning centers reached to 160, covering 51 cities by the end of this quarter. More specifically, we opened one learning center in each of the following 16 cities, which are Beijing, Dongguan, Changsha, Tianjin, Fushun, Nanchang, Wuhan, Jinzhong, Wuhu, Xuzhou, Suzhou, Jilin, Yantai, Jinan, Kunming and Harbin and opened 2 learning centers in Chongqing among which Jinzhong, Jilin, Wuhu, Xuzhou and Fushun are the 5 cities that we newly entered.

Shaoyun Han - *Tarena International, Inc. - Founder, Chairman of the Board and CEO*

(foreign language)



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Yuduo Yang - *Tarena International, Inc. - CFO*

We continue to focus on balancing utilization of facility resources and promoting center efficiency. Given that we opened more learning centers this quarter, the standard utilization rate slightly decreased to 69% compared with the same period last year. We believe that standard utilization rate will gradually go up to historical level as we enter into peak season.

Shaoyun Han - *Tarena International, Inc. - Founder, Chairman of the Board and CEO*

(foreign language)

Yuduo Yang - *Tarena International, Inc. - CFO*

As a key indicator that shows our education quality and outcome, job placement record is an operating metric that we always focus on. Six-month postgraduation job placement rate this quarter remained at high level as we did in previous quarters, which was above 95%. This outstanding result will further support our leading brand and overall competitive position in the industry.

Shaoyun Han - *Tarena International, Inc. - Founder, Chairman of the Board and CEO*

(foreign language)

Yuduo Yang - *Tarena International, Inc. - CFO*

Our non-GAAP operating margin this first quarter was negative 6.9%, slightly lower than the same period last year. This can be mainly attributable to the expansion plan we opened more centers while enter into more cities. Operational efficiency in these new centers and cities associated with -- or centers with -- associated with new cities are still in ramp-up period and have not yet reached to the similar level to the mature current centers, which will, in turn, affect overall operating margin. Furthermore, our K-12 business is still in a fast-growing period, resulting in a lower margin than mature professional education business in the short term. Our CFO, Dennis, will elaborate this -- this further in his later remarks.

Shaoyun Han - *Tarena International, Inc. - Founder, Chairman of the Board and CEO*

(foreign language)

Yuduo Yang - *Tarena International, Inc. - CFO*

To sum up, our efforts in expanding business skills for professional education services will drive further growth outlook, and revenue growth is expected to accelerate from the third quarter, which is the peak season in the year. Our effort in rolling out K-12 business has started to bear fruit with robust business momentum. Given that we have high base in net revenue during the [first] quarter of 2016, we expect to achieve higher revenue growth rate in the second half this year. Tarena has been well prepared in expanding teaching resources in operational facilities this quarter, which lay solid foundation to achieve our operational and financial target for the full year 2017.

Shaoyun Han - *Tarena International, Inc. - Founder, Chairman of the Board and CEO*

(foreign language)



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Yuduo Yang - Tarena International, Inc. - CFO

With that, I will now turn the call over to our CFO, Dennis Yang, to discuss first quarter financial results and outlook for the second quarter of 2017.

Thank you, [Han,] and hello everyone on the call. Since you have -- already have the detailed numbers in the press release, I will review financial results for this quarter briefly and only focus on a couple of more important areas.

Let's start with net revenue. For the first quarter of 2017, our net revenues increased by 23.5% year-over-year to RMB 333 million, which exceeded the high end of our revenue guidance we've previously issued. One major driver for net revenue growth is enrollment growth. Despite high comparison base for the quarter, total student enrollment increased by 20.6% year-over-year to 27,785. Total course enrollment, which is a primary driver for our revenue growth, increased by 16% year-over-year to 24,500.

Besides enrollment, ASP increase is another driver for our revenue growth. Average revenue per course enrollment in the quarter, as defined by net revenue divided by course enrollment, was RMB 13,240, which increased by 3.8% as compared to RMB 12,758 in the same quarter last year. Such an increase of average revenue per course enrollment were mainly attributable to the increase of our standard tuition by approximately RMB 1,000 for selected courses in March 2016.

Seat utilization rate is one of the key metrics measuring our operational efficiency of teaching resources. We opened 7 and 18 learning centers in the fourth quarter of 2016 and the first quarter of 2017, respectively. Utilization rate of such newly opened learning centers have not yet reached to the optimal level as compared with other more and more mature centers. Therefore, utilization rate for this quarter decreased by 2.1 percentage points to 68.6%.

In the first quarter, gross margin decreased by 2.8 percentage points to 61.6% as compared with the same quarter last year. Such a decrease in gross margin was mainly attributable to the following 2 reasons: one, end of utilization seat capacity in our professional education business as what I mentioned; and two, currently lower gross margin recorded in K-12 business than professional education segment in this quarter as K-12 business is still in its ramp-up period and utilization of K-12 teaching resources have not yet reached to its ideal level.

Now let's moving on to operating expenditures. We have been focusing on operational efficiency improvement and implementation of adequate controls over account receivables in the past 2 years. Our strategy will continue to implement further in 2017.

I would like to draw some following key points. Firstly, student acquisition cost is one of the largest operating expenditures. In this quarter, we continue to optimize student acquisition channel mix and improve our sales lead conversion. In term of student enrollment, search engines' contributions decreased to 47%. And on the contrary, acquisition from student referral and the classified website increased to 21% and 20%, respectively. Average advertising spending per student enrollment for the quarter was RMB 2,057, which was 4.7% higher than the amount in the same quarter last year.

This increase was mainly attributable to higher unit cost per student acquired from search engine channels since 2016, especially after Baidu revised its advertising policy in May 2016 and partially offset by the optimization of channel mix and improvement of sales lead conversion. Moving forward, we continue to optimize student acquisition channel mix and the target to remain advertising cost per student enrollment at a similar level to 2016.

Second, we recorded bad debt allowances for doubtful account receivables from 2014. As communicated previously, our bad expenses resulted from latency issue of installment payment plan extended by Tarena to our students. After having partnered with third-party financing providers and implemented strengthened internal controls over credit granting and cash collections, we well managed this latency issue. And in this quarter, bad debt expenses decreased by 35% from RMB 4.4 million in the same period last year to RMB 2.9 million this quarter. We believe that bad expenses for the fiscal year 2017 will further decrease as compared with the amount in 2016, reflecting the reduced proportion of students taking our credit and improved internal controls over account receivables.

Our non-GAAP operating loss for this quarter was RMB 23 million as compared with operating loss of RMB 3.9 million for the same quarter last year. Our net loss was RMB 24.6 million for the first quarter of 2017 compared to the net loss of RMB 24.5 million for the same quarter last year. Such



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increase in quarterly operating loss was attributable to the following couple of reasons: first, seasonal fluctuation in terms of enrollment and net revenues due to Chinese New Year in this quarter; two, costs associated with the new centers we recently opened and the new courses in our top line occurred ahead of the enrollment, the revenue ramp-up; and three, K-12 recorded operating loss in the short term because K-12 revenue recognized in the longer period, but its operating expenditures, especially marketing expenses, reported in income statement when occurred.

In terms of cash flow, we generated RMB 177 million in positive operating cash inflow in the first quarter 2017, almost triple the size of operating cash flow compared to the same quarter last year.

We believe that our efforts in expanding business skills for professional education services will help drive further growth outlook. And considering the high comparison base in the first half of 2016, revenue growth expected to accelerate in the peak season for the year. Our efforts in rolling out K-12 business will start to bear fruit and [rub] a business momentum for the rest of 2017.

Looking forward to the second quarter of 2017, the total net revenue is expected to be between RMB 443.5 million and RMB 456.5 million, representing an increase of 21.4% to 25% on a year-on-year book basis. We also [hear] from the full fiscal year 2017 revenue to be between RMB 1,990 million and RMB 2,070 million, representing an increase of 26% to 31% on a year-over-year basis.

Hello, operator?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). We will now take our first question from Alex Liu from Daiwa.

Alex Liu - Daiwa Securities Co. Ltd., Research Division - Research Analyst

(foreign language) I'll translate myself. First, on capacity growth. Can we talk about the 2017 capacity growth target and, also, the capacity growth plans in the coming 3 years? And also, what factors are the major constraint for our capacity expansion for -- plan? The second question is on the -- on our high-end class. Could the management talk about the -- what's the current scale of the high-end class, the subject cover by the high-end cohort and also specifically this employer profile difference for high end versus normal course?

Shaoyun Han - Tarena International, Inc. - Founder, Chairman of the Board and CEO

(foreign language)

Yuduo Yang - Tarena International, Inc. - CFO

Okay, back to your first question. The core concerns for Tarena's capacity expansion in the future couple of years as -- the supply of human resources. We believe professional education market size is quite huge. And in the recent couple years, we successfully entered in some third-tier cities, so we believe in this business area, there's still very big room to grow. So the core concern right now for Tarena is how to develop a good number of qualified people to join the team. That -- enough human resources supply is the core concern for our future expansion. So you observed in the third quarter 2017, we accelerated the pace for standard expansion, and we established or we set up Tarena training institute to provide trainings internally to our employees. So we believe we can -- to better develop our employees to fulfill our target for our future geographic expansion. Your second question about advanced courses. Currently, our advanced courses in Java, Digital art and WebFront, web software testing, in the past -- since last year, we implemented in teaching on the proper level strategy. We designed advanced level courses. In last year, we provide advanced courses in separate classes. That means we different classes for the basic class -- basic course and advance course. This means we can only implement this advanced courses teaching model in those big cities, in top cities. For example, one of our principle is the only -- the cities with -- per course,



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the monthly enrollment between 60 to 80 be [simple] for this kind of advanced courses development. But for other cities with, for example, 40 to 50 monthly enrollment that we no chance to run separate classes for advanced courses. So starting from this year, we will provide additional course content to more capable people, even those people -- those students are (inaudible) take courses with other people in basic courses. We will provide them additional courses for advanced course content, which has them 20% higher in their tuition. And for the monthly salary, other than their training, those students taking advanced courses will be on 30% or 40% higher than the students only gone through basic course.

Operator

The next question comes from the line of Andrew Orchard from Nomura.

Andrew John Orchard - *Nomura Securities Co. Ltd., Research Division - Research Analyst*

My question is on your deferred revenue growth. Just wondering why it is such a strong deferred revenue growth in the period yet the guidance is not that high. I understand that part of this due to the K-12 business, but this doesn't seem to fully explain the big difference. And then, the other question that I wanted to ask is with regards to your K-12 efficiency, right. I think in the call, Yang, you mentioned that the utilization of the K-12 resources is a little bit low. And I think that is probably due to low [synergy] ratios. So I just trying to understand what that synergy ratio is for the K-12 business? And also, if you could give us a sense of what the optimal level would be eventually. That would also be very helpful.

Shaoyun Han - *Tarena International, Inc. - Founder, Chairman of the Board and CEO*

(foreign language)

Yuduo Yang - *Tarena International, Inc. - CFO*

Andrew, for deferred revenue, your question is about deferred revenue growth is not in line with our revenue guidance for second quarter. My answer's here. Deferred revenue growth have a couple of drivers. And one of the drivers is K-12 business. Some -- all of the K-12 students pay their tuition upfront. For K-12 business, this revenue will be recognized in the longer period. Typically, 40 week -- in 40 weeks. So that business, the revenue will be not recognized that fast as compared to our professional business. [That's the first] reason. Second reason is difference from what we did in last year or in previous years. We started to accelerate the cash collection from our students. So we are not encourage the students to pay the tuition during their starting period. So most of our students needs to pay tuition upfront before they start training. So this strategy change will be -- help the company to collect more cash fast -- faster than before. So this also the contributor to the increase our net deferred revenue. So this the 2 main drivers for the increase of deferred revenue. Your question about K-12 utilization. Yes, you're right. K-12 business just started, so we roll out in 15 cities. So we placed tutors who are teachers in these 15 cities. But for these students, K-12 students at school who are not -- or the number of the students for K-12 at school were not as high as to the ideal level. So with the future fast-growing in this business segment, we believe the teacher and tutor ratio will be getting much better. Specifically, by the end of -- Q1 2017, our teachers for K-12 around

(technical difficulty)

oh, okay. Our K-12 student-tutor ratio will be 1:10. One teacher right now serve 10 students. But ideally, this student-tutor ratio will be higher than [1 50].

Operator

Your next question comes from the line of Zoe Zhao from Credit Suisse.



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Zoe Zhao - *Crédit Suisse AG, Research Division - Associate*

My first question is regarding the advertising expenses within the sales and marketing expenses. Can management give us an update on the referral rate during the quarter? And the second question is if we take your guidance for the full year in the second quarter, it seems that the second half revenue run rate will be over 30% versus our current capacity expansion, it's only around like 20%. So do we plan to increase our price by over 10% or like at even more capacity in the second quarter for the peak season? And the third question is regarding the gross profit margin for K-12 when the business stabilizes in the future. (foreign language)

Yuduo Yang - *Tarena International, Inc. - CFO*

Zoe, your first question about advertising. First, simply, the referral of -- our student referral right now took about 21% for the quarter. For advertising -- the advertising -- hold a second, let me check. It's about 40 -- advertising took about 40% of revenue. Selling marketing. Go ahead. (inaudible) question.

Helen Song

Advertising expenses just represents about 40% of the total selling and marketing expenses.

Yuduo Yang - *Tarena International, Inc. - CFO*

Zoe, your second question, we do both. We plan to do both. In the second quarter, we plan to open at least 10 new learning centers. We already opened 3 or 4 as of now, so we target to open more in the rest of second quarter. And we also try to increase ASP. As Ms. Helen mentioned, we'll roll out the new design advanced courses in Q2. So for this newly designed advanced courses, we'll charge additional tuition for those capable -- more capable people. So this also will be a driver to ASP increase going forward. So we do both. This is my -- our answer for -- to your second question. Your third question is about gross profit margin for K-12 at the optimal level. As we use -- for our K-12 business, we use prerecorded video plus teaching assistant. So with this hybrid learning model, simply very similar hybrid learn model, we are target very -- a still very high gross profit margin in this area. So that gross profit margin for K-12 at the optimal level will be somewhere 60% to 70%.

Operator

Your next question comes from the line of Johnny Wong from Jefferies.

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

I just have a strategic question. In the longer term, how does our cooperation with Microsoft -- how will that help our course design as well as tuition going forward? And when would we expect to be seeing these contributions? Would that be in the short term or in the long term?

Shaoyun Han - *Tarena International, Inc. - Founder, Chairman of the Board and CEO*

(foreign language)

Yuduo Yang - *Tarena International, Inc. - CFO*

We are cooperating with Microsoft in 2 fields. First, we believe Microsoft will have some technology advancement in VR and AR. So we partner with Microsoft to develop new courses in these 2 areas. And the second, we have partnered with Microsoft and K-12 higher education area that if our K-12 student gone through the certain competition that Microsoft will be our -- award a certain certificate -- a Microsoft certificate, MTA, is it? MTA certificate.



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Shaoyun Han - *Tarena International, Inc. - Founder, Chairman of the Board and CEO*

Yes, yes.

Yuduo Yang - *Tarena International, Inc. - CFO*

MTA certificate to those K-12 students. Johnny?

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

(foreign language)

Yuduo Yang - *Tarena International, Inc. - CFO*

You mean the new course?

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

Yes, yes.

Shaoyun Han - *Tarena International, Inc. - Founder, Chairman of the Board and CEO*

(foreign language)

Yuduo Yang - *Tarena International, Inc. - CFO*

We believe in the fourth quarter 2017, you will see the new courses will be launched.

Operator

(Operator Instructions) The next question comes from Eric Qiu from CCBI.

Lin Qiu - *CCB International Securities Limited, Research Division - Analyst*

I just want to ask how about the gross margin and OP margin trend going forward? Because you said we entering into some new areas which currently the utilization rate or margin ratio are relatively low. So I noticed that, first quarter, the GP margin was down about 3 percentage as well so OP margin down about 3 percentage. I was just wondering for next 3 quarters will both margin [issues] also down few percentage compared to last year. (foreign language)

Yuduo Yang - *Tarena International, Inc. - CFO*

We believe there will be gradual ramp-up in the margins in the following 3 quarters. So as we provide the general guidance for the whole year that the margins will be, to some extent, flattish in 2017 as compared to 2016. That means we got low margin in first quarter. And then, in Q2 through Q4, that the margin will be ramped up gradually, which resulted -- will be resulting from the ramp-up of new centers -- new centers in new cities as well as the new courses we plan to launch in the second half.



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Lin Qiu - *CCB International Securities Limited, Research Division - Analyst*

Okay. And my follow-up question is regarding to the new learning center because, apparently, you accelerated the new learning center opening up speed. I was just wondering for this year 2017, what should we expect the outcome? I was wondering if opening more new learning center, we'll have to raise the earnings or we'll bring down the margin more heavily because we have ramp-up period? (foreign language)

Shaoyun Han - *Tarena International, Inc. - Founder, Chairman of the Board and CEO*

(foreign language)

Yuduo Yang - *Tarena International, Inc. - CFO*

So we won't be -- take too long for the new centers to cap breakeven or to materialize. So my -- from my perspective that we target to open more new learning center before peak season. That means before Q3. And in Q3, this professional area -- this professional education business still be very big number of student to take classes. So if we can guide the new centers in operation before Q3, then we can realize the more student enrollment and more profit in the peak season for the year. So there won't be much impact, not adverse impact on the margin for the new centers. And back to what Mr. Han mentioned, the successful rate for opening new learning centers in the past couple of years for Tarena, those success rate quite high. So we are open new learning center based on our analysis of the market demand. So whenever we see through, there's enough market demand in that area, we open new learning center. So this helped Tarena to take pretty much in the straw period and now gone through ramp-up period for the new learning centers to -- are in a process.

Operator

There are no further questions at this time. Please continue.

Helen Song

Thank you, operator. I would now like to close the earnings call. Thank you for everyone to joining our call. And if there's any further questions, please welcome, everyone, to log on to our IR website at ir.tedu.cn. Thank you.

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