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TEDU - Q2 2014 Tarena International Inc Earnings Conference Call

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to Tarena International Incorporated Second Quarter 2014 earnings conference call. At this time, all participants are in a listen-only mode. After management's prepared remarks, there will be a question and answer session.

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. Christina Zhu, Tarena's investor relations manager.

Christina Zhu - *Tarena International Inc. - IR manager*

Thank you, Operator. Hello, everyone, and welcome to Tarena's Second Quarter 2014 earnings conference call. The company's earnings results were released earlier today, and were available on our IR website, ir.tarena.com.cn, as well as on news wire services.

Today you will hear opening remarks from Tarena's founder, chairman, and CEO, Mr. Shaoyun Han, followed by our chief financial officer, Suhai Ji, who will take you through the company's operational and financial results for the second quarter 2014, and give guidance for the third quarter and full year of 2014.

After their prepared remarks, Mr. Han and Mr. Ji will be available to answer your questions. Before we continue, please know 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 statement 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.tarena.com.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 I will translate.

Shaoyun Han - *Tarena International Inc. - CEO*

(interpreted) Thank you, Christina, and welcome, everyone, to our second quarter 2014 earnings conference call. I am very pleased that we achieved an excellent second quarter in 2014, reaching both record revenue and profit that exceeded our own expectations.

Our top line revenue grew by more than 53% year over year, to reach $31.9 million, exceeding our previously issued guidance. And our non-GAAP net income increased by almost 251% year over year to reach $7.2 million.

Our student enrollments in the second quarter of 2014 totaled 15,377, increasing by almost 36% year over year. Student enrollment growth was particularly strong in our newly-launched courses, digital arts, and online sales and marketing, which further validated our strategy to diversify our course offerings and revenues by expanding into other high-growth disciplines.

Our digital art and online sales and marketing courses continue their robust growth, and together accounted for more than 36% of the total student enrollments in the second quarter, as compared with 25% in the previous quarter.

Digital art course launched in the first quarter last year remained as our second largest course behind only Java, while online sales and marketing launched only in the fourth quarter last year, has now become our number four course after C++.

Given the success of our new course offerings, Java and C++, together now accounted for 43% of the total student enrollments, as of our second quarter, compared to 75% in the same period a year ago.

And in second quarter, after the enrollments from the retail channel increased 81% of the total student enrollment, compared with 72% in the same period in 2013, which resulted in higher average revenue per student. Combined with a tuition fee increase in the second quarter of 2014, this contributed to our revenue growth exceeding our student enrollment growth.

As expected, we had a higher percentage of student enrollments from the university channel in the second quarter, as compared to the first quarter, 19% versus 13%, which resulted in slightly lower average revenue per student when compared to that of the first quarter.

In terms of course offerings, we offer 11 courses in total in the second quarter of 2014, up from 9 in the same period a year ago, and unchanged from the previous quarter. As discussed in our last earnings call, we plan to allow one additional course in accounting by the end of 2014, and we are actually slightly ahead of schedule, and are ready to start our first trial class in Beijing, at the beginning of the fourth quarter.

In terms of new learning centers, we opened 10 in the second quarter of 2014, one each in Changchun, Changsha, Harbin, Jinan, Kunming, Qingdao, Shanghai, Wuhan, Xiamen, and Zhengzhou. We also merged three learning centers, one each in Hefei, Hangzhou, and two in Guangzhou into existing ones due to either the expiration of the lead contract, or changes to center management.

So effectively we added a net of six learning centers in the second quarter of 2014, and a net total of 11 in the first half of '14, compared with 19 in the first half of 2013. And we plan to open another 10 in the second half of 2014, compared with 16 in the second half of 2013.

As stated in the last earnings call, we have taken a prudent approach to new center openings in 2014, in order to continue to drive our margins and profitability. And one key objective and priority for 2014 that was set at the beginning of the year, was to drive our center efficiency and utilization rates, especially for newly opened centers.

I am pleased to report that we delivered on that promise in the first quarter, and again in the second quarter in terms of margin expansion.

Gross margin increased by 300 basis points year over year, to 71.2%, and non-GAAP operating margin increased by 610 basis points year over year, to 15.9% in the second quarter. Our overall center utilization rate already reached 70% in the second quarter of 2014, as compared to 66% in the same period a year ago.

In particular, I want to point out that our advertising and marketing expenses in the second quarter of 2014 accounted for 13% of total net revenues, compared to 16.7% in the same period in 2013.

Advertising and marketing expenses for student enrollment or student acquisition costs declined to $271 in the second quarter, from $306 in the same period a year ago. We will continue to focus on efficiency in our advertising and marketing spending to maintain a healthy balance between growth and profitability.

In the second quarter, the Chinese Bank Council issued the decision to accelerate modern vocational education, in order to encourage the further development of the professional education market, and to bridge the structural gap between the demand for and supply of skilled workforce.

The number of college graduates in China has risen to a record high of 7.3 million in 2014, and the employment market is becoming increasingly competitive. It is against such a backdrop that Tarena's consistent job placement rates of above 90% sets us apart, accentuates our brand and reputation in the industry.

We believe that as a leading professional education service provider with a proven track record of graduate success, Tarena is extremely well-positioned to continue to be benefited from the strong market environment, and capture the growth opportunities ahead.

With that, I will now turn the call over to our CFO, Suhai Ji, to discuss the second quarter financial results and outlook for the third quarter and full year 2014.

Suhai Ji - *Tarena International Inc. - CFO*

Thank you, Mr. Han. Thank you, Christina, and hello to everyone on the call. As Mr. Han mentioned, we are very pleased to have achieved another record quarter with both strong top and bottom line results. So now let me quickly review our financial results for second quarter of 2014.

Please note that unless stated otherwise, all numbers I will discuss today are in U.S. dollars. First, on the top line growth, our net revenues in the quarter increased by 53% year over year to $32 million.

The increase was primarily due to increased student enrollment, and higher average revenue per student, as defined by net revenues divided by student enrollment. Total student enrollments in the second quarter increased by 36% year over year to 15,377, which was driven by the number of popularity of our course offerings.

The number of our course offerings increased from 9 to 11 in the second quarter year over year, while the number of our learning centers increased from 76 to 103 in the same period year over year, to cater to the increased demand for our courses.

Average revenue per student in second quarter increased by 13% year over year to $2,089. The growth was mainly driven by the increase of standard tuition fees for our courses, and higher percentage of retail channel in our student enrollment channel mix.

Before moving on to the cost of revenues and operating expenses, I want to refer you to our disclosure on non-GAAP financial measures, which was included in our official press release. The only difference between our GAAP and non-GAAP numbers are share-based compensation, or SBC expenses.

SBC expenses included across cost of revenues and operating expenses on a GAAP basis, but excluded to derive our non-GAAP numbers. We have included a reconciliation table in our earnings release showing the detailed calculation.

In the second quarter of 2014, total SBC expenses were $1.4 million, up from $200,000 in the same period in 2013. More than 88% of the total SBC expenses this quarter fell in the general and administrative expense line, with the rest being relatively insignificant across the other expense line.

[Cost of] revenues in the second quarter of 2014 increased by 39% year over year, to $9.2 million. The increase was mainly due to higher rental costs, resulting from increased number of learning centers, and expansion of existing learning centers, higher personnel costs and [a welfare] expenses, resulting from increased number of teaching and advisory staff at our learning centers, and higher average salary, as well as higher depreciation expenses for our learning centers.

GAAP gross profit increased by 60% year over year to $22.7 million. GAAP gross margin increased by almost 300 basis points year over year, to 71.2%. The improvement in gross margin was mainly due to enhanced operational [normal] scale, and efficiency for our learning centers in terms of lower personnel costs and welfare expenses, as a percentage of net revenues, and lower rental expenses as a percentage of revenues.

Now moving on to operating expenses. Selling and marketing expenses increased by 34% year over year to $10.3 million. The increase was due to higher personnel costs and welfare expenses, related to the growth in our selling and marketing [cost], and higher average salary, and expended marketing effort, primarily as a result of increased spending on advertising as we expanded our network of learning centers.

Non-GAAP general and administrative expenses increased by 74% year over year to $6.2 million. The increase was mainly due to higher compensation cost for our increased number of general and administrative personnel, to support our growing operations, higher net debt allowance, and to a lesser extent, higher professional expenses.

Research and development expenses increased by 37% year over year, to $1.4 million. The increase was mainly due to the higher personnel costs and the welfare expenses of our instructors, allocated to their content development activities for our courses.

Our operating income increased by 95% to $3.6 million in the second quarter of 2014. Non-GAAP operating income increased by 150%, to $5.1 million. Non-GAAP operating margin increased to 15.9% in second quarter of 2014, as compared to 9.8% in same period in 2013.

In second quarter of 2014, we had a decrease in effective tax rate to 10.5% from 17.8% in same period in 2013. The decrease was primarily due to a tax holiday of a two-year full exception from 2014 to 2015, followed by three-year 50% exemption from 2016 to 2018, [entitled] by one of our wholly-owned subsidiaries, which is qualified as a newly established software enterprise under the PRC enterprise income tax law.

So our net income for the second quarter of 2014 increased by 205% to $5.7 million, compared with $1.9 million in same period in 2013. Non-GAAP net income for the quarter increased by 249% to $7.2 million, from $2.1 million in the same period in 2013.

So given our total basic share account of $50.7 million ADS, and fully diluted share count of $60.6 million post-IPO, our performer GAAP, basic, and the diluted earnings per ADS for the second quarter of 2014 were $0.113, and $0.099 respectively.

Non-GAAP, basic, and the diluted earnings per ADS were $0.142 and $0.125 respectively. In second quarter we also had a significant increase in cash, cash equivalents, and time deposit balance, from $38.3 million at the end of 2013, to $151.5 million at the end of the second quarter of 2014, because of the IPO proceeds of $109 million and also cash flow generated from operations.

So looking forward to the third quarter of 2014, we expect total net revenues to be in the range of $38.5 million, and $39.5 million, representing an increase of 35% to 39% on a year over year basis.

The company also expects its total net revenues for the full year 2014 to be between $134.5 million and $136 million, representing an increase of 44.9% to 46.5% on a year over year basis. This guidance reflects the company's current expectation, which is subject to change.

This concludes my remarks, and I will now hand the call over to the operator, and open the line for questions. Operator?

QUESTIONS AND ANSWERS

Operator

Thank you. We will now begin the question and answer session. (Operator Instructions) Your first question comes from the line of [Sei Fong] from Goldman Sachs. Your line is open. Please go ahead. [Sei Fong] from Goldman Sachs, your line is open. Please go ahead.

Unidentified Participant

Hi, good morning, (spoken in Chinese). Thanks for taking my question. Regarding the revenue guidance, the third quarter outlook implies a slow-down from the second quarter. I was wondering if you can discuss pricing and volume drivers behind the guidance, and also how should we think about the profitability target for the full-year? And then I have a follow up. Thank you.

Suhai Ji - *Tarena International Inc. - CFO*

Sure. I'll take this question. I think our Q3 guidance versus Q2, if you increase more than about 20% year, over year it's about 36% increase versus Q3 a year ago. We have decided to slightly reduce the full year revenue guidance against the street estimates, in light of our focus and priority on driving profit and the utilization in 2014.

But we are very confident to achieve the street estimates for the 2014 profit. And as you can see from our reported results that was just released in Q2, we moderated our advertising and marketing spending as a percentage of revenue in second quarter.

We want to continue to strike a healthy balance between growth and profitability for the remainder of the year. I want to reiterate however, that we still see a tremendous market opportunity, and feel incredibly well-positioned to capitalize on that.

And I would note that even taking the middle of the range for our full year guidance, we're projected 45% year over year growth, which positions us still as the fastest-growing education company among all publicly listed education companies from [greater] China. And we believe our margins will continue to expand for the rest of 2014, driven by the operating leverage, [it will be] our unique hybrid learning model.

Unidentified Participant

Thanks, Suhai. That's great to hear. And regarding the student acquisition, as [great Han Zhu] mentioned, that you are further optimizing the channels, I'm wondering if you can give us an update on the current advertising channels that you are using, and also the budget allocation across these channels. Thank you.

Suhai Ji - *Tarena International Inc. - CFO*

Yes, so for the acquisition channels, we did not the types of acquisitions. Still search engine advertising accounted for the bulk of our advertising budget. However, the progress we made in the second quarter, and also in the first quarter, is to optimize our search engine marketing, in terms of SEO and SEM.

And also for certain regions and learning centers, we're diversifying to a certain extent the other types of online advertising, for example our [fiftya.com], and our other recruiting websites. So the gain has mainly resulted from the efficiency in our marketing and ad spending.

Unidentified Participant

Understood. Thank you.

Shaoyun Han - *Tarena International Inc. - CEO*

(interpreted) Although we slightly lowered the top line guidance, our bottom line guidance and expectations remain on track. That's because the reason behind our slightly lowering of our top line growth is to optimize our operating efficiency. That's why we could achieve the same bottom line target with even slightly lowering our top line guidance.

Unidentified Participant

(spoken in Chinese) So my question is management can identify a specific, whether it's a course or a location that you are revising down the revenue guidance for.

Shaoyun Han - *Tarena International Inc. - CEO*

(interpreted) No, it's just a general management strategy to control the balance, and to control the pace of revenue growth.

Unidentified Participant

Thank you.

Operator

Your next question comes from the line of [Ella Ji] from [Open Highway]. Your line is open. Please go ahead.

Unidentified Participant

(spoken in Chinese) So my first question is if my calculation is correct, the total enrollments from Java may decline year over year in 2Q. I just wondered if management can explain what happened.

Suhai Ji - *Tarena International Inc. - CFO*

Yes, I'm happy to take that question, [Ella]. So we have achieved a great success in our new courses, like digital art and online sales marketing, both of which are growing very fast, and help further diversify our revenue, which in a sense also reduced the percentage of total students enrolled in some of the traditional courses, like Java and C++.

And actually a significant percentage of the students who come to Tarena, they come undecided on which course to take, and now we have a wider selection of high quality courses for them, that are designed to prepare them for the fast-growing job market in China.

And as we have discussed in the past, our new course offerings, they're based on the covered research on the local job markets, so we expect strong demand for training in those new offerings.

So that being said, the introduction of those new courses have given our students a greater selection overall, which we view as a significant positive for our business, and our brand long-term, even if it may result in some near-term enrollment dislocation in our legacy courses like Java and C++.

So on a year over year basis, we had a slight decline in the Java and C++ enrollment, which are more than made up for by the growth in some other newer courses. And we do not feel particularly concerned, because now we have much more diversified course offerings, and do not have any overweight dependence on any one single course.

Unidentified Participant

OK, thank you for the color, Suhai. My second question is, Han Shaoyun, I wonder if you can also share with us some of our thoughts relating to the strategy of pursuing utilization and profitability over the growth rate since your overall utilization has already been very high, and this quarter is 70%, it's definitely above the industry level.

So the question is how much higher do you think you can go? And do you think it's really worth it to pursue maybe another -- some more utilization growth over the growth rate? (spoken in Chinese)

Shaoyun Han - *Tarena International Inc. - CEO*

(interpreted) So there are two aspects that we are focusing on to increase our overall profitability and utilization. First is to increase utilization rates. So the overall utilization rates for Tarena in second quarter of 2014 is 70%, but our long-term target is between 75% to 80%.

Some of our mature centers have already reached 80%, but some are still below our average, around 60%, so we are confident that there is still lots of room for utilization rate to further increase.

And second aspect is to optimize our advertising organization and structure and our training system for our sales and marketing people. So we want to spend some time, spend one year to optimize our overall infrastructure, so we can get us ready to capture growth opportunities in the years ahead of us.

Suhai Ji - *Tarena International Inc. - CFO*

Yes, I just want to add that we're probably not sacrificing the revenue as we stated at the beginning of the year, last year was a big expansion year for us. We opened 35 learning centers, so our operating margin actually came down from close to 19% to 15%.

So the objective and priority we set for this year is to really drive the profitability to get our profitability margin back to the level we saw in 2012. We're still not there yet. We do have a half year to work on, so we want to have a very healthy balance between the top line growth versus the bottom line growth.

And we are confident that we can still achieve the street estimates for the bottom growth in terms of margin expansion, even in light of the slight lowered revenue, which is less -- around 3%.

Unidentified Participant

Got it. (spoken in Chinese)

Suhai Ji - *Tarena International Inc. - CFO*

Thank you, [Ella].

Operator

(Operator Instructions) Your next question comes from the line of Clara Fan from Jefferies. Your line is open. Please go ahead.

Clara Fan - *Jefferies Group Inc. - Analyst*

Hi, thank you for taking my question. I've got a question on the GNA as a percentage of sales, it was higher than what we expected, and we noted in the announcements that it was mainly due to higher [backed up] allowance, and higher professional expenses.

I'm just wondering how much are those two separately, and -- because from my understanding, [backed up] allowance should be coming down because we are no longer giving out student loans.

And secondly, in relation to the decision to accelerate more of vocational education, can you give us more color on it, on how we are going to benefit, and whether we can quantify it? Thank you.

Suhai Ji - *Tarena International Inc. - CFO*

Yes, hi, Clara. I will take your first question, and I have Han Shaoyun to address your second question. First question, yes, in the GNA category, among all the detailed items, the number one is personnel costs and welfare, and that increased by 35% year over year.

So in terms of dollar amount, it's about $700,000, because we increased the number of centers, hired more admin people, and -- finance people, before the IPO, and that's quite reasonable. And the second biggest item in Q2 is that net debt allowance.

Yes it's true that we generally got rid of the installment payment option, but the fact that went out in Q2, mainly due to a couple of reasons, first is our cash collections feed was slower than the growth of the overdue AR balance.

So we actually collected more than $5 million [RNB] in second quarter, but 2012, that was a peak enrollment year for the legacy installment payment plan, and many students are still repaying us now, so it's taking longer to digest the AR from that year.

But as we discussed previously, we [went] down that payment option in beginning of 2013, so last year. So again, this is a legacy issue that will be resolved once we digest associated AR balance.

And secondly that's relatively new, is for students who are receiving loans from the banks, so who are paying us up front by getting the loans from the bank, the approval process usually takes about 1 to 2 months.

And if the loan is not approved or dispersed by the time students enrolled in classes, we need to make that allowance as well, but that amount usually gets fully paid as soon as the loan is approved. And historically, this non-collection from this source has been negligible, so this is only temporary.

And the other reason for the cash collection that will take a longer period of time, even though our overall balance will not grow, but it has to do with the collection speed versus the agent speed of the AR balance.

Clara Fan - *Jefferies Group Inc. - Analyst*

So approximately how much was the backed up allowance last quarter?

Suhai Ji - *Tarena International Inc. - CFO*

About $1.5 million, but please remember, those are the allowance that we made. They do not mean that we would not be able to collect them, and they will only impact the balance sheet, not the income statement. So it went up by another $500,000.

Clara Fan - *Jefferies Group Inc. - Analyst*

Yes. And the professional expenses, how much are they?

Suhai Ji - *Tarena International Inc. - CFO*

That's not much. For the last quarter, professional expenses went up about $140,000. That mainly has to do with the audit, lawyer, legal fees.

Clara Fan - *Jefferies Group Inc. - Analyst*

OK, thank you.

Suhai Ji - *Tarena International Inc. - CFO*

OK, I will have Han Shaoyun to address your second question. (spoken in Chinese) That was your second question, right, Clara? About the impact of the recent resolution by the state council?

Clara Fan - *Jefferies Group Inc. - Analyst*

Yes.

Shaoyun Han - *Tarena International Inc. - CEO*

(interpreted) So in the long term it's definitely a great news for Tarena, because basically the government is encouraging universities to work with enterprises to strengthen the training for skilled workforce, and training the college students on practical skills.

So that translates to more opportunities for Tarena to work with colleges and universities. So on one aspect, we expect the policy to further develop. In the last quarter, we signed a cooperation contract with 6 universities in [Jung Su] province to build joint major programs.

So that means from the first year, the major will integrate professional training service providers institute into the college curriculum, and the university will share tuition revenue with us, Tarena.

And right now we have only seen such deep cooperation, like joint major programs, in the southern part of China, due to the further development of local policies. And going forward, we hope the northern part of China will follow the practice in the southern part, and we'll hope to see more joint major programs cooperation in the northern and south area going forward.

Clara Fan - *Jefferies Group Inc. - Analyst*

I've got one follow up question on -- for these joint majors, what's the tuition fee? Like would that be lower than from a retail channels, and what's the margins like? Thank you.

Suhai Ji - *Tarena International Inc. - CFO*

It would be lower, but it would come at a much lower marketing spending. Because if you imagine once universities sign those joint major program with us, so the students are almost automatically enrolled in this program. So that does not incur any marketing or ad spending on the part of Tarena. So it's still a very, very good business for us.

Shaoyun Han - *Tarena International Inc. - CEO*

(interpreted) Yes, and mostly the courses are hosted at universities' facilities, so that would not take up our space in our learning centers, and that will save additional cost as well.

Clara Fan - *Jefferies Group Inc. - Analyst*

Thank you.

Suhai Ji - *Tarena International Inc. - CFO*

OK, any next question?

Operator

Your next question comes from the line of [Xiaolung Xi] from Credit Suisse. Your line is open. Please go ahead.

Unidentified Participant

Hi. Yes, good morning, Han Shaoyun and Christina. Thanks for taking my question. I just wonder if management can share your thoughts on the broad IT professional training market, and just wondered from management perspective if there's any change in the students' demand for (inaudible) courses, or if there's any change in the competitor landscape now, compared to year beginning.

And my second question is about how many quarters you guys expect this internal restructuring may last before you can achieve the desired operating efficiency? Thank you. (spoken in Chinese)

Shaoyun Han - *Tarena International Inc. - CEO*

(interpreted) To address your first question regarding the overall market environment, we have seen two changes. First, on the demand side, in your last quarter, the IT industry the first time overpassed [real asset] industry, and has become the largest employing industry.

So that also translates to our own graduates employment rate in the second quarter as reached record high of 95% post-graduation employment rate. And the second change we have seen is we are seeing more students from non-IT background interested in IT -- in our training services. Currently about 50% to 60% of our students, they are from non-computer science majors. So those are the two changes that we are seeing in the overall market environment.

So your second question regarding the schedule and progress of our optimizing project. So we are optimizing three aspects, the first on advertising spending, the second on organizational structure, and third a training system for our employees.

The first one, first aspect, advertising spending regarding seeing encouraging results from this optimizing aspects, so that's one part finished and accomplished. And second part regarding organizational structure, it's ongoing, and we are expecting another quarter to finish the process.

And third, the training system for our employees, we are also pushing it forward. We are expecting another quarter to accomplish that. So overall we are expecting the optimization schedule to wrap up toward the end of this year in the fourth quarter. So for the next year, we are hoping to be ready for expansion and growth.

Unidentified Participant

Thank you.

Operator

(Operator Instructions) Thank you, and I'll revert the call to Christina Zhu, Tarena's investor relations manager.

Christina Zhu - *Tarena International Inc. - IR manager*

Thank you, Operator. If there are no further questions at present, we'd like to conclude by thanking everyone for joining us on the call. We welcome you to reach out to us directly by e-mailing ir@tarena.com.cn, should you have any questions or requests for additional information, and encourage you to visit our investor relations website at ir.tarena.com.cn. This concludes Tarena's earnings conference call. Thank you, everyone.

Operator

That does conclude our conference for today. Thank you for participating. You may all disconnect.

Editor: Portions of this transcript that are marked (interpreted) were spoken by an interpreter present on the live call. The interpreter was provided by the Company sponsoring this Event.
