

C1Q19: Regulation headwind past...BUY TAL and EDU

- We expect tutoring demand to shift to TAL and EDU due to the shutdown of small institutions. We believe regulations are helping TAL and EDU by increasing the entrance barrier for K12 tutoring business;
- We see EDU's expansion strategy begin to have payoff as it continues to fill up learning centers. On the other hand, as TAL slows down its capacity expansion last year, we expect its non-GAAP operating margin will recover better than consensus expects this quarter;
- Raise TAL and EDU's TP from US\$32 and US\$82 to US\$40 and US\$100, respectively. Reiterate our BUY rating on TAL and EDU.

Regulation is helping TAL and EDU

As our publication on December 28, 2018, "[Regulation nearing its end... BUY TAL and EDU](#)" points out, regulations have paved the ground for big after school tutoring (AST) and both TAL and EDU will benefit from the regulations. Recent AST policy development in Sichuan province further confirmed our view. Sichuan government will start to control the number of teaching licenses, which make it more difficult for new AST institutions to enter this market.

We expect TAL and EDU to post strong numbers

Our F4Q19 and F3Q19 top line, operating profit, and net income estimates are 1.6%, 6.7% and 4.5%; and 2.5%, 6.0% and 5.0%, respectively, versus the consensus for TAL and EDU. We expect TAL and EDU to issue F4Q19 and F3Q19 top line guidance 1.9% and 1.6% higher than consensus.

Slow expansion improves TAL's margin

As TAL slowed its learning center expansion in C2018, we expect its utilization to continue to increase, which leads to a margin recover. We estimate TAL will have a F4Q19 non-GAAP operating margin 0.8ppt higher than consensus due to this utilization improvement.

Regulation impacted EDU less than our expectation

We expect margin dragged down due to regulation is ~1%, less than ~1.5% we previously estimated. Therefore, we expect EDU will have a better non-GAAP operating margin performance in this quarter. We estimate EDU will have a F3Q19 non-GAAP operating margin 0.4ppt higher than consensus.

Key financial of stock mentioned

(US\$m)	Revenues			Non-GAAP op.profit			Non-GAAP NI		
	F2018A	F2019E	F2020E	F2018A	F2019E	F2020E	F2018A	F2019E	F2020E
TAL	1,715	2,528	3,620	256	401	601	249	433	544
EDU	2,319	3,089	4,391	304	354	483	337	403	506

Source: Bloomberg, Blue Lotus (as of April 15, 2019)

BUY

HOLD

SELL

What has changed

	To	From
TAL Education	US\$40	US\$32
New Oriental Education	US\$100	US\$82

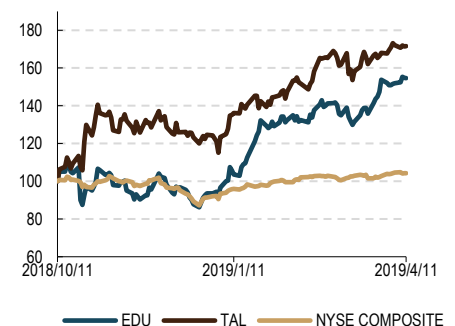
Source: Blue Lotus (as of April 15, 2019)

Stocks mentioned

Name	BBG code	Rating	TP	Curr. price	Next yr PE
TAL Education	TAL	BUY	US\$40	37.0	42
New Oriental Education	EDU	BUY	US\$100	90.1	29

Source: Blue Lotus (as of April 15, 2019)

Price performance and volume data



Source: Bloomberg (as of April 15, 2019)

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TAL Education Group: Financial Summary

Fiscal year ends-28-Feb

Exhibit 1. Income statement

USD (mn)	FY2018A	FY2019E	FY2020E
Net Revenues	1,715	2,528	3,620
Cost of Revenues	(882)	(1,177)	(1,671)
Gross profit	833	1,351	1,949
Selling and Marketing	(242)	(480)	(694)
General and Administrative	(386)	(557)	(796)
SBC	(47)	(81)	(136)
Government Subsidies	5	7	7
Income from operation	209	320	466
Non-GAAP operating income	256	401	601
Interest Income/Expense	23	47	38
Other Income/expense	17	107	0
Impairment Loss on LT Investment	1	(51)	0
Earnings before Taxes	250	424	504
Provision for Income Tax	(45)	(60)	(84)
Loss from Equity Method Inv.	(8)	(14)	(14)
Earnings of Discontinued Operations	0	0	0
Minority Interest (After Tax)	4	2	3
Net Income to TAL	202	352	409
Non-GAAP Diluted EPADS	0.43	0.72	0.88

Source: TAL Education Group, Blue Lotus (as of April 15, 2019)

Exhibit 2. Balance sheet

USD (mn)	FY2018A	FY2019E	FY2020E
Current Assets	1,662	1,790	2,081
Cash and Cash Equivalents	712	1,145	1,783
Short-term Investments	787	787	787
Other Current Assets	155	321	341
Non-Current Assets	1,393	1,496	1,685
Property and Equipment, net	247	370	522
Long-term Investments	598	598	598
Deferred Tax Asset, Non-current	17	17	17
Goodwill and Intangible	291	291	291
Other Non-Current Assets	239	219	256
Total Assets	3,055	3,757	4,610
Current Liabilities	1,133	970	906
Accounts Payable	58	49	103
Deferred Revenue-current	824	672	363
Income Tax Payable	14	8	9
Other Current Liabilities	238	241	432
Non-Current Liabilities	281	281	281
Long-term Debts	225	225	225
Bond Payable	11	11	11
Other Non-Current Liabilities	45	45	45
Total Shareholders' Equity	1,621	2,485	3,388
Minority Interest	20	22	25
Total Liabilities & Shareholders' Equity	3,055	3,757	4,610

Source: TAL Education Group, Blue Lotus (as of April 15, 2019)

Company Description

TAL, founded in 2003, is a leading K-12 after-school tutoring education company. Through F2Q19, it has covered 42 cities in China, with 594 learning centers. Net revenue reached US\$ 1.72bn in FY2018. We expect revenue to be US\$ 2.53bn in FY2019.

Industry View

We expect China private in-school-teaching (IST) market to grow 26%, 25%, and 23%, respectively, in 2018-2020, with private as total IST rising from 13.4% to 15.8%. We expect China's after-school-tutoring (AST) market to grow 4%, 3.9% and 3.9%, and after-school-activities (ASA) market to grow 23%, 21%, and 19%, respectively, in 2018-2020, with ASA as total after-school sector rising from 16.7% to 21.6%. We estimate total IST sector to be Rmb3.1tn and ASA sector be Rmb1.1tn in 2018.

Exhibit 3. Cash flow statement

USD (mn)	FY2018A	FY2019E	FY2020E
Net Income	202	352	409
Depreciation & Amort.	51	51	78
Amort. of Goodwill and Intangibles	8	2	0
Stock-Based Compensation	47	81	136
Change in working capital			
-Inventories	(2.5)	(0.3)	(4.3)
-Acc. Payable	31	(8)	53
-Unearned Rev.	323	280	330
-Inc. Taxes	(116)	(5)	1
-Def. Taxes	5	0	0
-Other Net Operating Assets	120	(185)	132
Cash from Operation	669	135	497
Capital Expenditure	(126)	(174)	(230)
Other Investing Activities	(713)	0	0
Cash from Investing	(840)	(174)	(230)
Cash from Financing	428	0	0
Foreign Exchange Rate Adj.	(32)	0	0
Cash beginning	487	712	1,145
Cash End	712	1,145	1,783

Source: TAL Education Group, Blue Lotus (as of April 15, 2019)

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New Oriental Education: Financial Summary

Fiscal year ends-31-May

Exhibit 4. Income statement

RMB(mn)	F2018A	F2019E	F2020E
Revenues	15,841	21,098	29,992
Cost of revenues	(6,899)	(9,366)	(13,313)
Gross profit	8,942	11,732	16,679
Gross margin	56.4%	55.6%	55.6%
Sales & marketing	(2,098)	(2,677)	(3,901)
G&A	(5,134)	(7,084)	(10,078)
Share based compensation	(368)	(445)	(600)
Profit from operations, non-GAAP	2,078	2,416	3,299
Profit from operations, GAAP	1,710	1,971	2,699
Other income	610	770	600
Profit before taxation, GAAP	2,320	2,741	3,299
Taxation	(385)	(433)	(443)
Profit for the year, pro forma	2,302	2,754	3,457
Profit for the year, GAAP	1,935	2,309	2,857
EPADS, pro forma, diluted	14.52	17.33	21.84

Source: New Oriental Education, Blue Lotus (as of April 15, 2019)

Exhibit 5. Balance sheet

RMB(mn)	F2018A	F2019E	F2020E
Cash and cash equivalents	6,785	8,989	11,227
Short-term Investments	11,204	11,204	11,204
Account Receivable	22	29	42
Term Deposits	743	743	743
Inventory	277	376	535
Prepaid expenses	1,256	1,706	2,425
Other current assets	11	11	11
Total current assets	20,299	23,059	26,187
Property, plant and equipment	3,102	4,171	5,885
Intangibles and goodwill	59	69	65
Long-term Investments	2,990	2,990	2,990
Other non-current assets	996	996	996
Total non-current assets	7,147	8,226	9,935
Total assets	27,446	31,285	36,122
Account payable	275	374	531
Accrued expense and other current liabilities	2,577	3,433	4,880
Income tax payable	464	464	464
Deferred revenue	8,764	9,063	8,848
Other current liabilities	0	0	0
Total current liabilities	12,081	13,334	14,723
Long-term debt	84	84	84
Total liabilities	12,165	13,417	14,807
Total equity	13,742	16,304	19,737
Total liabilities and equity	27,446	31,285	36,122

Source: New Oriental Education, Blue Lotus (as of April 15, 2019)

Company Description

New Oriental, founded in 1993, is a leading education company in China. EDU provides a wide range of educational programs, services and products, including English and other foreign language training, overseas and domestic test preparation courses, all-subjects after school tutoring, primary and secondary school education as well as online education.

Industry View

We expect China private in-school-teaching (IST) market to grow 26%, 25%, and 23%, respectively, in 2018-2020, with private as total IST rising from 13.4% to 15.8%. We expect China's after-school-tutoring (AST) market to grow 4%, 3.9% and 3.9%, and after-school-activities (ASA) market to grow 23%, 21%, and 19%, respectively, in 2018-2020, with ASA as total after-school sector rising from 16.7% to 21.6%. We estimate total IST sector to be Rmb3.1tn and ASA sector be Rmb1.1tn in 2018.

Exhibit 6. Cash flow statement

RMB(mn)	F2018A	F2019E	F2020E
Net income	1,935	2,309	2,857
Depreciation and Amortization	532	710	991
Stock-based compensation expense	396	445	600
Inventories	(40)	(99)	(159)
Account receivable	5	(7)	(12)
Tax payable	107	0	0
Account payable	95	98	157
Deferred revenue	2,307	2,000	1,000
Other operating activities	53	406	728
Cash generated from operations	5,390	5,862	6,162
Capital expenditure	(1,478)	(1,927)	(2,679)
Sale of PPE	68	0	0
Cash acquisition	(7)	(50)	(50)
Divestitures	20	20	20
Sale (Purchase) of Intangible assets	0	0	0
Invest. in Marketable & Equity Secur.	(384)	0	0
Net (Inc.) Dec. in Loans Originated/Sold	0	0	0
Other Investing Activities	(1,025)	0	0
Cash from investing	(2,806)	(1,957)	(2,709)
Cash from financing	(1,033)	0	0
Foreign Exchange Rate Adj.	295	0	0
Cash and cash equivalents, begin	4,370	6,785	8,989
Cash and cash equivalents, end	6,785	8,989	11,227

Source: New Oriental Education, Blue Lotus (as of April 15, 2019)

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Exhibit 7. TAL F4Q19 Preview Table

(US\$ mn)	F4Q19E	F4Q19C	F3Q19A	QoQ	F4Q18	YoY	F1Q20E	F1Q20C
Revenues	691	681	586	18%	504	37%	727	725
Cost of revenues	(318)		(268)	19%	(247)		(340)	
Gross profit	373		318	17%	257	45%	387	
Gross margin	53.9%	53.6%	54.3%	(0.4ppt)	51.1%	2.9ppt	53.2%	
Operating costs & expenses								
- Sales and marketing	(139)		(102)	37%	(78)	78%	(113)	
- G&A	(154)		(146)	5%	(112)	37%	(162)	
-Government Subsidies	0.1		0.4	(63%)	0.1	-	5.1	
Among which: Share-based compensation	(26)		(22)	18%	(13)	105%	(27)	
Operating profit, pre SBC	105	98	93	14%	79	33%	144	
Operating margin,pre SBC	15.3%	14.5%	15.9%	(0.6ppt)	15.8%	(0.5ppt)	19.8%	
Operating profit, GAAP	80	75	71	12%	67	19%	117	
Operating margin,GAAP	11.5%	10.9%	12.1%	(0.6ppt)	13.3%	(1.8ppt)	16.1%	
Other income	4		67	(93%)	13	(65%)	9	
Pretax profit, GAAP	84		138	(39%)	80	5%	126	
Income tax	(14)		(10)	38%	(9)	65%	(21)	
Minority Interest (After Tax)	0.6		0.2	248%	1.1	(45%)	0.7	
Net income, GAAP	70	67	128	(45%)	72	(3%)	106	
Net margin	10.2%	9.9%	21.8%	3.8ppt	14.3%	(8.8ppt)	14.6%	
EPADS, non-GAAP, diluted	0.15	0.15	0.24	(36%)	0.14	11%	0.21	
EPADS, GAAP, diluted	0.11	0.12	0.21	(46%)	0.12	(5%)	0.17	

Source: TAL, Bloomberg, Blue Lotus (as of April 15, 2019)

Exhibit 8. EDU F2Q19 Preview Table

(RMB mn)	F3Q19E	F3Q19C	F2Q19A	QoQ	F3Q18A	YoY	F4Q19E	F4Q19C
Revenues	5,377	5,248	4,121	30%	3,894	38%	5,867	5,776
Cost of revenues	(2,339)		(2,071)	13%	(1,694)		(2,506)	
Gross profit	3,038		2,050	48%	2,200	38%	3,361	
Gross margin	56.5%	56.3%	49.7%	7ppt	56.5%	-	57.3%	57.4%
Operating costs & expenses								
- Sales and marketing	(604)		(632)	(4%)	(486)	24%	(778)	
- G&A	(1,859)		(1,626)	14%	(1,346)	38%	(2,041)	
Among which: Share-based compensation	(123)		(95)	30%	(144)	(14%)	(135)	
Operating profit, pre SBC	698	659	(114)	N.M.	511	37%	676	646
Operating margin,pre SBC	13.0%	12.6%	(2.8%)	16ppt	13.1%	(0ppt)	11.5%	
Operating profit, GAAP	575		(208)	N.M.	368	56%	541	
Operating margin,GAAP	10.7%		(5.1%)	16ppt	9.4%	1ppt	9.2%	
Other income	150		258	(42%)	136	10%	150	
Pretax profit, GAAP	725		49	N.M.	504	44%	691	
Income tax	(122)		(0)	N.M.	(84)	44%	(140)	
Net income, GAAP	604	575	49	N.M.	420	44%	551	629
Net margin	11.2%	11.0%	1.2%	10ppt	10.8%	0ppt	9.4%	
EPADS, non-GAAP, diluted (RMB)	4.60	4.59	0.93	396%	3.62	27%	4.34	4.37
EPADS, GAAP, diluted (RMB)	3.82	3.57	0.33	1049%	2.71	41%	3.50	3.94

Source: EDU, Bloomberg, Blue Lotus (as of April 15, 2019)

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Equity rating allocation as of 12 April, 2019

Buy	50%	Hold	37%	Sell	13%
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Buy : The stock is expected to have an absolute return of more than 15-20% within 12 months

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