

## Regulation nearing its end...BUY TAL and EDU

- We expect impact of the after-school-tutoring (AST) crackdown to draw to a close soon. TAL and EDU will benefit from industry consolidation;
- We see EDU raise price for K12 classes and TAL reaccelerate in LC expansion in C4Q18, and we expect tutoring demand to shift to TAL and EDU due to the shutdown of small institutions;
- TAL is more dedicated to quality education and made good progress in B2B compared to EDU. Keep TAL and EDU TP unchanged at US\$33 and US\$80, respectively. Reiterate our BUY rating on TAL and EDU.

### AST regulation is nearing its end

We see regulation is speeding up on AST inspections in C4Q18. As Ministry of Education announced, 94% of AST institution already finished the rectification on December 24. We believe regulation headwind will likely end at C1Q19. After C1Q19, we expect most regulatory measures to ease to support economic growth. Education is no exception.

### Early compliance will benefit from online regulation

We see regulation moving to online in 2019. Shanghai has already enacted the detailed regulation for online education. We expect other cities to follow. We believe many online education names are ill-prepared for the upcoming regulation, with two issues being likely to hit very hard: (1) collecting cash over three months, (2) inadequate teaching licenses among their teaching staffs. The cash flow problem will be particularly life-threatening for online education institutions. Offline players like TAL and EDU, being already in compliance and equipped with offline student acquisition channel, will take market share from pure online education names, in our view. We particularly endorse TAL's B2B strategy which provides dual-teacher classroom solution to in-school-teaching (IST) institutions.

### We expect TAL and EDU to post strong numbers

Our F3Q19 and F2Q19 top line, operating profit and net income estimates are 1.0%, 0.3% and 0.2%, and 1.2%, 0.4% and 0.1%, respectively, versus the consensus for TAL and EDU. We expect TAL and EDU to issue F4Q19 and F3Q19 top line guidance of 2.2% and 3.1% above 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	2,530	3,892	256	328	558	249	324	530
EDU	2,447	3,146	4,529	301	318	552	280	429	630

Source: Bloomberg, Blue Lotus (as of December 27, 2018)

BUY

HOLD

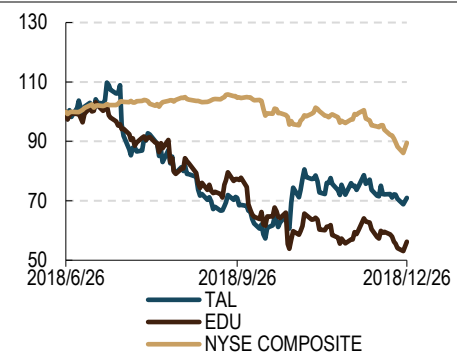
SELL

#### Stocks mentioned

Name	BBG code	Rating	TP	Curr. price	Next yr PE
TAL Education	TAL	BUY	US\$33	26.61	37
New Oriental Education	EDU	BUY	US\$80	53.47	17

Source: Blue Lotus (as of December 27, 2018)

#### Price performance and volume data



Source: Bloomberg (as of December 27, 2018)

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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	2,530	3,892
Cost of Revenues	(882)	(1,202)	(1,829)
Gross profit	833	1,328	2,063
Selling and Marketing	(242)	(495)	(758)
General and Administrative	(386)	(578)	(855)
SBC	(47)	(66)	(101)
Government Subsidies	5	7	7
Income from operation	209	261	457
Non-GAAP operating income	256	328	558
Interest Income/Expense	23	59	61
Other Income/expense	17	8	0
Impairment Loss on LT Investment	1	(10)	0
Earnings before Taxes	250	319	519
Provision for Income Tax	(45)	(52)	(82)
Loss from Equity Method Inv.	(8)	(12)	(12)
Earnings of Discontinued Operations	0	0	0
Minority Interest (After Tax)	4	3	5
Net Income to TAL	202	258	430
Non-GAAP Diluted EPADS	0.43	0.54	0.84

Source: TAL Education Group, Blue Lotus (as of December 27, 2018)

## Exhibit 2. Balance sheet

USD (mn)	FY2018A	FY2019E	FY2020E
Current Assets	1,662	2,252	3,393
Cash and Cash Equivalents	712	1,135	2,204
Short-term Investments	787	787	787
Other Current Assets	1631	330	402
Non-Current Assets	1,393	1,497	1,710
Property and Equipment, net	247	370	540
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	221	264
Total Assets	3,055	3,750	5,104
Current Liabilities	1,133	1,543	2,366
Accounts Payable	58	52	115
Deferred Revenue-current	824	1,227	1,803
Income Tax Payable	14	14	(35)
Other Current Liabilities	238	251	483
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	1,903	2,429
Minority Interest	20	22	28
Total Liabilities & Shareholders' Equity	3,055	3,750	5,104

Source: TAL Education Group, Blue Lotus (as of December 27, 2018)

## 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	258	430
Depreciation & Amort.	51	51	78
Amort. of Goodwill and Intangibles	8	2	2
Stock-Based Compensation	47	66	101
Change in working capital			
-Inventories	(2.5)	(0.5)	(5.3)
-Acc. Payable	31	(6)	63
-Unearned Rev.	323	402	577
-Inc. Taxes	(116)	0	(49)
-Def. Taxes	5	0	0
-Other Net Operating Assets	120	(176)	120
Cash from Operation	669	597	1,317
Capital Expenditure	(126)	(174)	(248)
Other Investing Activities	(713)	0	0
Cash from Investing	(840)	(174)	(248)
Cash from Financing	428	0	0
Foreign Exchange Rate Adj.	(32)	0	0
Cash beginning	487	712	1,135
Cash End	712	1,135	2,204

Source: TAL Education Group, Blue Lotus (as of December 27, 2018)

See the last page of the report for important disclosures

## New Oriental Education: Financial Summary

Fiscal year ends-31-May

### Exhibit 4. Income statement

RMB(mn)	F2018A	F2019E	F2020E
Revenues	15,841	21,705	31,251
Cost of revenues	(6,899)	(9,716)	(13,812)
Gross profit	8,942	11,989	17,439
Gross margin	56.4%	55.2%	55.8%
Sales & marketing	(2,098)	(2,947)	(3,923)
G&A	(5,134)	(7,307)	(10,335)
Share based compensation	(368)	(460)	(625)
Profit from operations, non-GAAP	2,078	2,195	3,806
Profit from operations, GAAP	1,710	1,735	3,181
Other income	610	1,582	2,002
Profit before taxation, GAAP	2,320	3,317	5,183
Taxation	(385)	(357)	(838)
Profit for the year, pro forma	2,302	3,421	4,970
Profit for the year, GAAP	1,935	2,960	4,345
EPADS, pro forma, diluted	14.52	21.43	30.94

Source: New Oriental Education, Blue Lotus (as of December 27, 2018)

### Exhibit 5. Balance sheet

RMB(mn)	F2018A	F2019E	F2020E
Cash and cash equivalents	6,785	10,949	15,461
Short-term Investments	11,204	11,204	11,204
Account Receivable	22	30	43
Term Deposits	743	743	743
Inventory	277	390	555
Prepaid expenses	1,256	1,770	2,516
Other current assets	11	11	11
Total current assets	20,299	25,097	30,533
Property, plant and equipment	3,102	4,227	6,048
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	8,282	10,099
Total assets	27,446	33,379	40,632
Account payable	275	388	551
Accrued expense and other current liabilities	2,577	3,532	5,085
Income tax payable	464	464	464
Deferred revenue	8,764	10,377	10,953
Other current liabilities	0	0	0
Total current liabilities	12,081	14,761	17,053
Long-term debt	84	84	84
Total liabilities	12,165	14,844	17,137
Total equity	13,742	16,939	21,843
Total liabilities and equity	27,446	33,379	40,632

Source: New Oriental Education, Blue Lotus (as of December 27, 2018)

### 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	2,960	4,345
Depreciation and Amortization	532	710	995
Stock-based compensation expense	396	460	625
Inventories	(40)	(113)	(165)
Account receivable	5	(8)	(13)
Tax payable	107	0	0
Account payable	95	112	163
Deferred revenue	2,307	1,613	576
Other operating activities	53	441	807
Cash generated from operations	5,390	6,176	7,333
Capital expenditure	(1,478)	(1,982)	(2,792)
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)	(2,012)	(2,822)
Cash from financing	(1,033)	0	0
Foreign Exchange Rate Adj.	295	0	0
Cash and cash equivalents, begin	4,370	6,785	10,949
Cash and cash equivalents, end	6,785	10,949	15,461

Source: New Oriental Education, Blue Lotus (as of December 27, 2018)

See the last page of the report for important disclosures

## Regulation have paved the ground for big AST

- **TAL and EDU should benefit from regulation:** We see AST regulation is increasing the cost of doing business for AST institution. Naturally, small AST is much more vulnerable than big AST. As a result, lots of small AST institution just have to exit the market. Therefore, TAL and EDU will benefit from the industry consolidation.

*Big AST will benefit from this regulation.*
- **EDU raised the price in C4Q18:** Our tracking data shows EDU raised K12 price in Beijing and Shanghai. We also observe that, for cities with stricter regulation, prices increase more. Beijing raised prices more than 20% and Shanghai raised price about 7%. We believe the reason behind this is that in a city with stricter regulation, many small AST institutions closed, and more demand is placed on big AST institutions.

*EDU raised K12 classes price*
- **TAL and EDU are opening learning centers in C4Q18:** After a long period of refraining from opening new learning centers, our tracking data shows TAL opened 39 new learning centers in C4Q18 (as of the end of December 14). Our tracking data also shows EDU opened about 90 K12 learning centers in C4Q18 (as the end of December 14). We believe this should also another signal that demand for big AST institutions is increasing thanks to the regulation.

*TAL and EDU are opening more learning centers*
- **AST demand in first tier cities still increase:** We see the number of newborns still remain at a high level in first tier cities. As the school resources remain limited, we believe this would increase the AST demand in first tier cities.

*First tier cities demand is increasing*
- **TAL is more dedicated to quality education investment:** In 2018, TAL's investment deals have 6 (out of 16) about quality education while EDU has 3 (out of 12). We see EDU is trying to catch up to TAL in online education in 2018 (5 out of 12 investment deals are about online education). We believe the fall behind on online education will make EDU put less attention to quality education in C2019.

*TAL is moving ahead on quality education*
- **TAL's exploring in B2B business deserve kudos:** We see that TAL is exploring B2B business using the *magic school*(未来魔法校) to provide services for small tutoring institution. We believe this will be another solution for TAL to penetrate lower tier cities. Currently, TAL already provide this product to more than 200 tutoring institution.

*B2B business will be another long-term driver*
- **Winter will pass soon:** In the macroeconomic downturn, we believe government will be more tolerant to the AST industry. At the same time, as 2018 regulation already paved the ground for TAL and EDU by closing many small AST institutions. We believe industry consolidation will accelerate. In fact, we already see the signal from price increases and new learning centers opening. Keep TAL and EDU TP unchanged at US\$33 and US\$80, reiterate our BUY rating.

*Industry consolidation will be easier than before*

### Exhibit 7. EDU K12 class price tracking data

Update time	2017 autumn class (Nov. quarter)	2017 winter class (Feb. quarter)	2018 spring class (May. quarter)	2018 summer class (Aug. quarter)	2018 autumn class (Nov. quarter)	2018 winter class (Feb. quarter)	2019 spring class (May. quarter)
Beijing (RMB/hr)	49	78	68	79	73	92	83
% change (QoQ)	N.A.	N.A.	N.A.	N.A.	49.00%	17.90%	22.10%
Shanghai (RMB/hr)	83	84	87	89	89	90	93
% change (QoQ)	N.A.	N.A.	N.A.	N.A.	7.20%	7.10%	6.90%

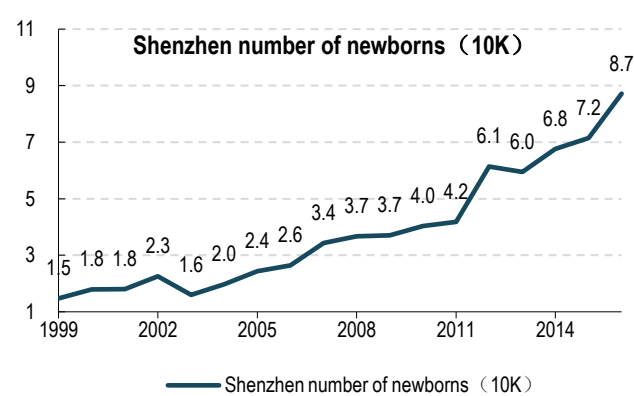
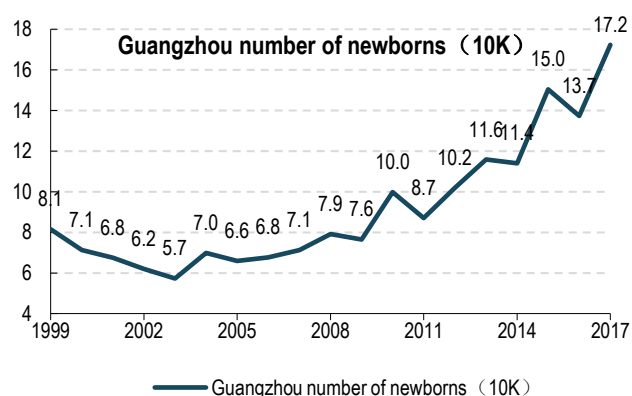
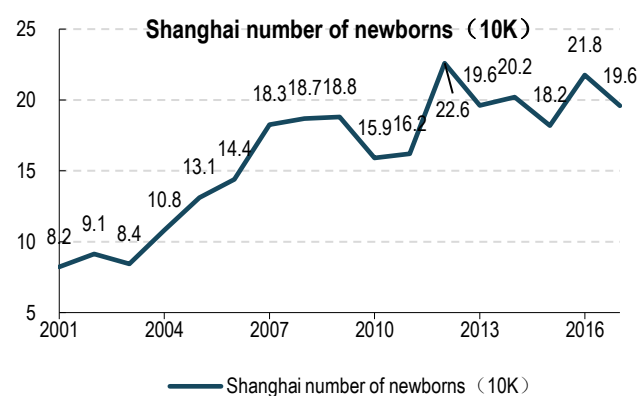
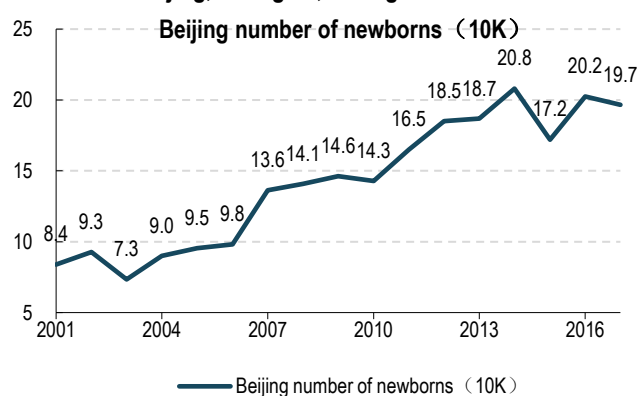
Source: Blue Lotus (as of December 27)

### Exhibit 8. EDU and TAL learning centers tracking data

Update time	Aug. 14	Sep. 14	Oct. 14	Nov. 14	Dec. 14
EDU K12 Learning centers	1,331	1,298	1,248	1,389	1,388
% change (MoM)		(2.50%)	(3.90%)	11.30%	(0.10%)
TAL Learning centers	431	422	418	442	461
% change (MoM)		(2.10%)	(0.90%)	5.70%	4.30%

Source: Blue Lotus (as of December 27)

### Exhibit 9. Beijing, Shanghai, Guangzhou and Shenzhen number of newborns



Source: China National Bureau of Statistics (as of December 27)

**Exhibit 10. TAL's investment deal in 2018**

<i>Announced data</i>	<i>Investment or Acquisition</i>	<i>Company</i>	<i>Type</i>
2018/12/4	Acquisition	Code Monkey	Quality education
2018/10/29	Investment	Qinbaobao (亲宝宝)	Baby
2018/10/24	Investment	July Education (七月在线)	Quality education
2018/9/28	Acquisition	Dr. Panda (熊猫博士)	Baby
2018/9/16	Investment	Fclassroom (极课大数据)	B2B
2018/9/12	Investment	Aomeng Programming (傲梦编程)	Quality education
2018/8/3	Investment	Yuangaofen (元高分)	B2B
2018/6/14	Investment	Hualala (画啦啦)	Quality education
2018/6/8	Investment	Jisuanke (计蒜客)	Quality education
2018/6/4	Investment	Zhishiquan (知识圈)	Online
2018/5/23	Investment	Zhishifenzi (知识分子)	Others
2018/4/25	Investment	KnowBox (作业盒子)	Online
2018/3/22	Investment	Myguancha (母婴行业观察)	Baby
2018/1/8	Investment	DadaABC (哒哒在线少儿英语)	Online
2018/1/5	Investment	Drosophila Academy (德拉学院)	Quality education
2018/1/4	Investment	Haifeng Education (海风教育)	Online

Source: Blue Lotus (as of December 14)

**Exhibit 11. EDU's investment deal in 2018**

<i>Announced data</i>	<i>Investment or Acquisition</i>	<i>Company</i>	<i>Type</i>
2018/9/14	Investment	Lai Offer (来 offer)	Online
2018/8/28	Investment	Topschools (顶思)	Oversea education
2018/8/6	Investment	Xiaohe (小禾科技)	Online
2018/7/7	Investment	Zhang Tong Jia Yuan (掌通家园)	Online
2018/6/27	Investment	AeroSpace Maker (航天创客)	Quality education
2018/6/11	Investment	Youbeile (优贝乐)	Baby
2018/6/1	Investment	Moblab	Quality education
2018/4/24	Acquisition	Tolobear (多乐小熊)	Baby
2018/4/12	Investment	Boxfish (盒子鱼)	Online
2018/4/3	Investment	Unicareer	Online
2018/2/5	Investment	Cui Yutao Paediatrics (育学园)	Baby
2018/1/22	Investment	Jikestar (极客晨星)	Quality education

Source: Blue Lotus (as of December 14)

**Exhibit 12. TAL F3Q19 Preview Table**

(US\$ mn)	F3Q19E	F3Q19C	F2Q19A	QoQ	F3Q18	YoY	F4Q19E	F4Q19C
<b>Revenues</b>	<b>581</b>	<b>575</b>	<b>700</b>	<b>(17%)</b>	<b>433</b>	<b>34%</b>	<b>700</b>	<b>685</b>
Cost of revenues	(279)		(330)	(15%)	(221)		(333)	
Gross profit	302		370	(19%)	212	42%	367	
Gross margin	51.9%	51.9%	52.9%	(1.0ppt)	49.0%	3.0ppt	52.4%	53.5%
Operating costs & expenses								
- Sales and marketing	(106)		(152)	(30%)	(62)	72%	(138)	
- G&A	(146)		(139)	5%	(106)	38%	(167)	
-Government Subsidies	0.6		1.2	(49%)	0.6	-	0.1	
Among which: Share-based compensation	(15)		(18)	(17%)	(12)	23%	(18)	
<b>Operating profit, pre SBC</b>	<b>65</b>		<b>99</b>	<b>(34%)</b>	<b>57</b>	<b>14%</b>	<b>81</b>	
Operating margin,pre SBC	11.2%		14.1%	(3.0ppt)	13.2%	(2.0ppt)	11.6%	
<b>Operating profit, GAAP</b>	<b>50</b>	<b>50</b>	<b>81</b>	<b>(38%)</b>	<b>45</b>	<b>11%</b>	<b>63</b>	<b>77</b>
Operating margin,GAAP	8.6%	8.7%	11.6%	(3.0ppt)	10.4%	(1.8ppt)	9.0%	11.2%
Other income	7		15	(51%)	11	(35%)	7	
Pretax profit, GAAP	57		96	(40%)	56	2%	70	
Income tax	(9)		(16)	(42%)	(11)	(21%)	(11)	
Minority Interest (After Tax)	0.2		0.8	(69%)	1.0	(78%)	0.5	
<b>Net income, GAAP</b>	<b>48</b>	<b>48</b>	<b>81</b>	<b>(40%)</b>	<b>46</b>	<b>6%</b>	<b>60</b>	<b>79</b>
Net margin	8.4%		11.6%	3.8ppt	10.6%	(8.8ppt)	8.5%	
		0.2%						
<b>EPADS, non-GAAP, diluted</b>	<b>0.10</b>	<b>0.11</b>	<b>0.16</b>	<b>(36%)</b>	<b>0.10</b>	<b>5%</b>	<b>0.12</b>	<b>0.15</b>
<b>EPADS, GAAP, diluted</b>	<b>0.08</b>	<b>0.08</b>	<b>0.13</b>	<b>(40%)</b>	<b>0.08</b>	<b>2%</b>	<b>0.09</b>	<b>0.13</b>

Source: TAL, Capital IQ, Blue Lotus (as of December 27)

**Exhibit 13. EDU F2Q19 Preview Table**

(RMB mn)	F2Q19E	F2Q19C	F1Q19A	QoQ	F2Q18A	YoY	F3Q19E	F3Q19C
<b>Revenues</b>	<b>4,062</b>	<b>4,012</b>	<b>5,732</b>	<b>(29%)</b>	<b>3,083</b>	<b>32%</b>	<b>5,480</b>	<b>5,313</b>
Cost of revenues	(2,017)		(2,450)	(18%)	(1,500)		(2,438)	
Gross profit	2,045		3,283	(38%)	1,584	29%	3,042	
Gross margin	50.4%	50.6%	57.3%	(7ppt)	51.4%	(1ppt)	55.5%	56.2%
Operating costs & expenses								
- Sales and marketing	(655)		(662)	(1%)	(476)	38%	(683)	
- G&A	(1,605)		(1,558)	3%	(1,194)	34%	(1,900)	
Among which: Share-based compensation	(93)		(93)	1%	(61)	52%	(126)	
<b>Operating profit, pre SBC</b>	<b>(122)</b>	<b>-118</b>	<b>1,156</b>	<b>(111%)</b>	<b>(25)</b>	<b>390%</b>	<b>585</b>	<b>565</b>
Operating margin,pre SBC	(3.0%)	(3.0%)	20.2%	(23ppt)	(0.8%)	(2ppt)	10.7%	
<b>Operating profit, GAAP</b>	<b>(215)</b>		<b>1,063.0</b>	<b>(120%)</b>	<b>(86)</b>	<b>149%</b>	<b>459</b>	
Operating margin,GAAP	(5.3%)		18.5%	(24ppt)	(2.8%)	(2ppt)	8.4%	
Other income	199		-90	(321%)	157	26%	278	
Pretax profit, GAAP	-16		973	(102%)	71	(123%)	737	
Income tax	5		(171)	(103%)	(20)	(123%)	(123)	
<b>Net income, GAAP</b>	<b>-12</b>	<b>-12</b>	<b>802</b>	<b>(101%)</b>	<b>51</b>	<b>(123%)</b>	<b>613</b>	<b>555</b>
Net margin	(0.3%)	(0.3%)	14.0%	(14ppt)	1.7%	(2ppt)	11.2%	
		0.1%						
<b>EPADS, non-GAAP, diluted (RMB)</b>	<b>0.60</b>	<b>0.40</b>	<b>5.71</b>	<b>(89%)</b>	<b>0.63</b>	<b>(4%)</b>	<b>4.72</b>	<b>3.83</b>
<b>EPADS, GAAP, diluted (RMB)</b>	<b>0.01</b>	<b>-0.15</b>	<b>5.13</b>	<b>(100%)</b>	<b>0.24</b>	<b>(94%)</b>	<b>3.93</b>	<b>3.48</b>

Source: EDU, Capital IQ, Blue Lotus (as of December 27)

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### Equity rating allocation as of December 21, 2018

Buy	64%	Hold	23%	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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