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SOHU.OQ - Q2 2018 Sohu.com Ltd Earnings Call

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## OVERVIEW:

SOHU reported 2Q18 total revenues of \$486m. Co. expects 3Q18 total revenues to be \$445-470m and GAAP loss per fully-diluted ADS to be \$1.50-1.75m.



## CORPORATE PARTICIPANTS

**Charles Zhang** *Sohu.com Limited - Chairman & CEO*

**Eric Yuan**

**Joanna Lv** *Sohu.com Limited - CFO & Principal Accounting Officer*

## CONFERENCE CALL PARTICIPANTS

**Eddie Leung** *BofA Merrill Lynch, Research Division - MD in Equity Research and Analyst*

**Yiu Hung Chong** *Crédit Suisse AG, Research Division - Regional Head of Internet*

**Yue Wu** *China International Capital Corporation Limited, Research Division - Analyst*

## PRESENTATION

### Operator

Ladies and gentlemen, thank you for standing by, and good evening. Thank you for joining Sohu's Second Quarter 2018 Earnings Conference Call. (Operator Instructions) Today's conference call is being recorded. If you have any objections, you may disconnect at this time. I would now like to turn the conference over to your host for today's conference call, Mr. Eric Yuan, Investor Relations Director of Sohu. Please go ahead, sir.

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### Eric Yuan

Thanks, operator. Thank you for joining us today to discuss Sohu's second quarter 2018 results. On the call are Chairman and the Chief Executive Officer, Dr. Charles Zhang; CFO, Joanna Lv. Also with us today are Changyou's CEO, Dewen Chen; and the CFO, Yaobin Wang. Before management begins their prepared remarks, I would like to remind you of the company's safe harbor statement in connection with today's conference call.

Except for the historical information contained herein, the matters discussed in this conference call are forward-looking statements.

These statements are based on current plans, estimates and projections, and therefore, you should not place undue reliance on them.

Forward-looking statements involve inherent risks and uncertainties.

We caution you that a number of important factors could cause actual results to differ materially from those contained in any forward-looking statement.

For more information about the potential risks and uncertainties, please refer to the company's filings with the Securities and Exchange Commission, including its registration statement and the most recent annual report on Form 10-K.

With that, I will now turn the call over to Dr. Charles Zhang. Charles, please proceed.

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### Charles Zhang - Sohu.com Limited - Chairman & CEO

Thank you, Eric, and thanks to everyone for joining our call. We saw mixed financial performance in the second quarter. While quarterly revenue was slightly soft given the continued headwinds against our brand enterprising business, the bottom line performance was better than expected than -- as we aggressively slashed content costs.



For Sohu Media, we continued to focus on user growth for the Sohu News App by consistently refining the product design and the content quality. For video, for Sohu Video, we maintained steady momentum with our original content and substantially narrowed the loss as a result of lower spending on licensed content.

For Sogou, in the second quarter, its core search revenue posted 45% year-over-year growth, and Sogou Mobile Keyboard's daily active user increased by 36% from prior year to now 380 million DAU.

Changyou delivered in-line performance as its online game business continued to generate healthy cash flow.

Before I give more details about our key businesses, let me summarize our financial results for the second quarter.

Total revenue's \$480 million -- \$486 million, up 5% year-over-year and 7% quarter-over-quarter. Net brand advertising revenue's \$62 million, down 29% year-over-year and up 9% quarter-over-quarter. Search and search-related advertising revenue's \$270 million, up 45% year-over-year and 23% quarter-over-quarter. Online game revenue's \$94 million, down 23% year-over-year and 11% quarter-over-quarter.

Now let me go through some of the key businesses. First, media business. For the second quarter, we continued to work hard on growing the user base for the Sohu News App, and we made some good progress. One important area is the breadth and depth of content. We believe that Sohu should always be a reliable source for our users can use on daily basis. We introduced a new column called the Sohu Moment that helps you to quickly see the hottest stories that are happening in China and abroad each day. We send you this alert in real time when there are developments related to topics that are interesting. And the new page design makes it more conveniently for users to post a comment in those stories. We also signed up many independent contributors under friendly financial terms to read the quality of articles for our news service.

In addition, we spent more on promoting the Sohu News App on various distribution channels. In particular, we formed a partnership with some large smartphone makers like Huawei. As a result of these efforts, DAU and user time spent on Sohu News App trended well during the quarter, and we expect the momentum to continue into the second half of 2018.

Having said that, advertising revenue fell short of our estimate as spending from large customers are -- was soft. We faced a tougher operating environment as new players, including short video platforms, competed for ad budgets. Amid the very competitive market conditions as our traffic is growing, we expect a gradual ramp-up in our ad revenues, especially those from media enterprises in the coming quarters.

Now moving over to Sohu Video. Over the past few quarters, we have pursued a revamped content strategy that turn our focus to original content and short-term -- short-form video programs. We've saved a significant amount on content costs as a result, so that we were able to rapidly reduce the overall loss for Sohu Video.

Excluding onetime items, the overall content cost was cut by more than 50% from the same quarter last year, and our operating loss decreased by about 40% from a year ago. With respect to our original content, we are developing a series of high-quality original drama shows with a reasonable budget. In June, we released Medical Examiner Dr. Qin (foreign language) Season 2. Leveraging season 1's popularity, the new drama collected good viewership numbers and helped expand our subscriber base.

Our reality shows such as (foreign language) and (foreign language) also got positive reviews from critics upon their debuts. Looking ahead, we plan to launch at least one new drama each month in 2018 and selectively produce more variety shows. And with the execution of our new coming strategy, the loss of Sohu Video is soon to be further narrowed over the next 2 quarters.

Overall, the Sohu Media and Sohu Video, our imminent priority is to drive monetization while keeping costs under strict control. We're committed to improving our margin quarter-by-quarter.

Next, moving to Sogou. In the second quarter, Sogou maintained healthy growth as we continued to deliver differentiated content on Sogou Search results. During the quarter, we took the initiatives to better integrate Sogou Mobile Keyboard with Sogou Search and use our big data analytics based on the information captured by Sogou Mobile Keyboard.



Sogou's market share in China's mobile search market was 17.8% and remained as the #2 player, according to iResearch by June.

With respect to our partnership with WeChat, Sogou provided increasing search services. In its own search result, WeChat started to display content from Sogou (foreign language) and Sogou (foreign language), our user-editable encyclopedia and interactive question-and-answer platform.

Lastly, for Changyou, Changyou's core game business performed well in the second quarter. For its PC game, revenue was flat compared with prior quarter. Thanks to the launch of new expansion pack celebrating TLBB's 11th anniversary, revenue of TLBB PC was steady, exceeding our expectation. For mobile games, the pace of the revenue decline the pace of revenue decline of Legacy TLBB mobile continued to slow as we launched its first and new expansion pack. We introduced upgraded character design and scenarios, and we also unveiled a new plan, new social functionality and a Battle Royale-style game play.

Now let me turn the call over to Joanna, who will walk you through the financial results. Joanna?

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**Joanna Lv** - *Sohu.com Limited - CFO & Principal Accounting Officer*

Thank you, Charles. I will go through the key financials for our 4 major segments.

For the second quarter of 2018, all of the numbers that I will mention are all under non-GAAP basis. You may find a reconciliation of non-GAAP to GAAP measures on our IR website.

For Sohu Media Portal, revenues were \$33 million, down 20% year-over-year. The quarterly loss was \$37 million, which compares with a net loss of \$10 million in the second quarter of 2017.

For Sohu Video, revenues were \$32 million, down 26% from year ago. Of this, advertising revenues were \$60 million. The quarterly loss was \$35 million, which compares with a net loss of \$103 million in the same quarter last year.

For Sogou, total revenues were \$301 million, up 43% year-over-year and up 21% quarter-over-quarter. Net income was \$38 million, up from \$24 million in the same quarter last year.

For Changyou, total revenue, including 17173, were \$130 million, down 25% year-over-year and 18% quarter-over-quarter. Changyou posted a net income of \$28 million compared with net income of \$61 million in the same quarter last year.

For third quarter of 2018, we expect total revenues to be between \$445 million and \$470 million; Brand Advertising revenues to be between \$60 million and \$65 million. This implies annual decrease of 13% to 20% and a sequential decrease of 2% and a sequential increase of 6%; Sogou revenues to be between \$275 million and \$285 million. This implies an annual increase of 7% to 11% and a sequential decrease of 5% to 9%; online game revenues to be between \$80 million and the \$90 million. This implies annual decrease of 32% to 40% and a sequential decrease of 5% to 15%.

Before deducting the share of non-GAAP net income pertaining to noncontrolling interest, non-GAAP net loss to be between \$44 million and \$54 million. Assuming no new grants of share-based awards and that the market price of our share is unchanged, we estimate that the compensation expense relating to share-based awards will be around \$5 million. Including the impact of this share-based award, GAAP net loss before noncontrolling interest to be between \$49 million and \$59 million, non-GAAP net loss attributable to Sohu.com Limited to be between \$55 million and \$65 million and non-GAAP loss per fully diluted ADS to be between \$1.40 and \$1.65, including the impact of aforementioned share-based awards and netting of around \$2 million of Sohu's economic interest in Changyou and Sogou. GAAP net loss attributable to Sohu.com Limited to be between \$58 million and \$68 million and GAAP loss per fully diluted ADS to be between \$1.50 and \$1.75.

For third quarter of 2018 guidance, we used a presumed exchange rate of RMB 6.8 to \$1, which compares with actual exchange rate of approximately RMB 6.38 to \$1 for second quarter of 2018, and RMB 6.67 to \$1 for third quarter of 2017.



This concludes our prepared remarks. Operator, we would now like to open the call to questions.

## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions) Your first question comes from the line of Thomas Chong from Crédit Suisse.

### Yiu Hung Chong - *Crédit Suisse AG, Research Division - Regional Head of Internet*

I have 2 questions. The first one is about the competitive landscape for news feeds market and how we should think about the trends in second half, the second half and 2019. And my second question is about the original content strategy and how we differentiate from our peers. And if there's any update about the timing of breakeven of our video business would be great.

### Charles Zhang - *Sohu.com Limited - Chairman & CEO*

Okay. Thank you. So the competitive landscape for News App, we expect the trend of growth of DAUs will continue into the second half of the year. And also in my prepared remarks, I mentioned our partnership with Huawei, the channel distribution actually, that spending of the cost of that part is still not generating the DAUs yet because it's installed and the smartphone need to be sold to actually end users, and then it's activated. So in Q1 and Q2's app deal growth, that spending on Huawei channels, that part has not contributed to the growth yet. So that's -- so it will show up in Q3 and Q4 gradually and -- but not only the channel but the overall improvement of the -- our common quality and also the algorithm for the information stream. And also Sohu's news, the positioning of it is -- differentiate ourselves as a news provider, so that the quality of news so that even -- that's for the News App. So we would -- we expect to continue to grow and also more inventories will be created, and then they will contribute to our gradual ramp-up of advertising revenue, especially from SMEs. Your next question about the Sohu Video original content, we are already differentiating ourselves. And so with the current level of spending, the original content and the dramas and also variety shows, especially now we use our own -- we signed our own actor and actress, so that the cost of actors and actresses is not sky-high. And so with the current level of spending, we can maintain the current DAUs and also H5 video views and also actually expect the growth. So that we're looking at, let's see, probably -- I think probably Q2 or Q3, Sohu Video will reach profitability next year.

### Eric Yuan

Next year.

### Charles Zhang - *Sohu.com Limited - Chairman & CEO*

Yes.

### Operator

Your next question comes from the line of Eddie Leung from Merrill Lynch.



**Eddie Leung** - BofA Merrill Lynch, Research Division - MD in Equity Research and Analyst

Charles, just a follow-up question on original content under your video business. Could you also comment a little bit on the industry's production costs? It seems like most of the peers also going into original content. Just wondering whether that would affect the overall production costs for Sohu Video and any strategy to differentiate would be helpful, if you can.

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**Charles Zhang** - Sohu.com Limited - Chairman & CEO

Yes, that's the -- our peers and competitors are still -- even they are going into original content, they are spending much more than us and also still buying those very expensive head content from -- that -- so that's the way we do it. We actually already discovered or find -- found a unique path toward the future by -- for low-budget drama, TV drama series, episodes by having just a better team to really have the kind of -- we basically can create a quality drama TV series under about \$2 million actually, USD 2 million, \$2 million to \$3 million apiece for like 20 episodes TV dramas and then also with basically a coordinated marketing over on the Sohu platform, so that we can make a low-budget episode and make it really in terms of traffic and brand name popularity actually and almost as important as a hit, as a habit, has a large margin video. This is not exactly correlated. If you spend a lot of money, it does not -- sometimes, it doesn't actually generate good content.

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**Operator**

Your next question comes from the line of Natalie Wu from CICC.

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**Yue Wu** - China International Capital Corporation Limited, Research Division - Analyst

Two questions here. First of all, it's about Sohu Video. So just wondering what's the run rate of Sohu Video's loss at the current stage? And how should we look at that going forward? Should we be concerned about the cash adequacy of the -- of your company in near term? Second question is about Sohu News App. Just curious about the current level of Sohu News App MAU and DAU. And what should we see the growth rate about the 2 operating metrics going forward?

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**Charles Zhang** - Sohu.com Limited - Chairman & CEO

First of all, the Sohu Video, the current loss of the quarter is \$35 million. And if you look at the history, last year, actually Q2 last year is almost -- over \$100 million. And then actually Q1 of 2018, it's \$48 million. So you see a trend basically coming down. Well, in terms of cash flow, I think we buy -- we have enough cash because it's now become controlled -- I mean, it's under control now. So we're looking at this current quarter, it's \$35 million loss, and next quarter, we will have -- we will reduce it more. We will have further reduction. And then -- so as I said, it will be next Q2 or Q3, Sohu Video will be profitable. And for Sohu News App, did we -- do we have -- did we publish the DAU, MAU? No. No, we're not giving out for competitive...

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**Eric Yuan**

Talent growth.

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**Charles Zhang** - Sohu.com Limited - Chairman & CEO

Yes, we are not giving the overall number of the MAU for competitive reasons. But we do see a very healthy growth over last quarter, 2 quarters actually. In growth in terms of DAU, it grew by 40% or 50%, right?



**Eric Yuan**

Yes.

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**Charles Zhang** - *Sohu.com Limited - Chairman & CEO*

And then video, it's doubled or almost like tripled.

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**Yue Wu** - *China International Capital Corporation Limited, Research Division - Analyst*

Sorry, the DAU is growing at 40% to 50% on year-on-year basis. Is that correct?

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**Charles Zhang** - *Sohu.com Limited - Chairman & CEO*

It's just that we were just at a low point last year, end of last year and through the improvement, and it has really picked up speed. Basically, I'm mean, it's really catching up. So it's grown -- over the last 6 months, it has grown already in terms of DAU over 40%

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**Operator**

(Operator Instructions) There are no further questions at this time. I would now like to hand the conference back to Mr. Eric Yuan for his closing remarks. Please continue.

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**Eric Yuan**

Thank you all for joining this call, and have a good evening, and good day. Yes.

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**Operator**

Ladies and gentlemen, that does conclude our conference for today. Thank you for participating. You may all disconnect.

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