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CMCM - Q2 2018 Cheetah Mobile Inc Earnings Call

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PRESENTATION

Operator

Hello, and welcome to the Cheetah Mobile Second Quarter 2018 Earnings Conference Call. (Operator Instructions) Please note, this event is being recorded. Now I would like to turn the call over to Helen Zhu, IR Director. Please go ahead, ma'am.

Helen Jing Zhu

Thank you, operator. Welcome to Cheetah Mobile's Second Quarter 2018's Earnings Conference Call. With us today are Mr. Fu Sheng, Chairman and CEO; and Mr. Vincent Jiang, CFO. Following management's prepared remarks, we will conduct a Q&A session. A presentation for the company's earnings call is also available at the company's IR website. Before we begin, I refer you to the safe harbor statements in our earnings release, which also applies to our conference call today as we will make forward-looking statements. At this time, I would now like to turn the conference call over to our CEO, Mr. Fu Sheng. Please go ahead, Fu Sheng.

Sheng Fu - Cheetah Mobile Inc. - Chairman of the Board & CEO

Thanks, Helen. Hello, everyone. Thank you for joining us today. As we said on our Q1 earnings call, we had implemented some initiatives regarding our exciting business including mobile utility products and our mobile game business. I'm delighted that the efforts are starting to bear fruit.

In Q2, total revenues were RMB 1.1 billion beating our high-end revenue guidance by 2%, non-GAAP operating profits growth by 58% year-over-year to RMB 143 million. We now expect our total revenues in Q3 to be in the range of RMB 1.29 billion to RMB 1.35 billion, representing a 10% to 15% year-over-year growth. This growth will be driving by our utility products and related service business and our mobile game operation. Now I will highlight some of our initiatives around our utility products business and our mobile game operation. First, we have been paying more attention to our domestic market. Our mobile utility products in China and overseas market used to be operated by separate teams. We have now combined the teams and applied many approaches that have been proving effective in the overseas market to our home market. As a result, the DAU of Clean Master exceeded the 30 million mark in June in our domestic market. Revenues from mobile utility products in the domestic market grow substantially in the quarter. This growth was achieved even in unfavorable market environment where some Chinese advisers in the news, live streaming and short video sectors scaled back their online promotions -- promotional activities due to tightened regulation regarding online content.

In the overseas market, we have tried our several initiatives to monetize Cheetah Keyboard and have some encouraging initial results. Cheetah Keyboard has accumulated more than 10 million DAU mainly through organic growth. In Q2, utility product and related services business generated RMB 756 million in revenue and RMB 282 million in non-GAAP operating profit. It remained as a most important source of cash for us. Second, our portfolio of major games has continued to achieve strong performance. We have introduced popular third-party contents into our games to encourage game purchase. For example, in the quarter, we added a new lever to Dancing Line, Piano Tiles 2 and the Rolling Sky-based some popular song, which attracted a lot of active players and allowed us to convert many of them into paying users.



Furthermore, the profitability of our major games continues to increase, thanks to our operating leverage. We had a temporary delay in launching some new mobile games in Q2, which resulted in decline in revenue in Q2. But we have seen some of our new games, Tiles, started to run off quickly in early July.

Going forward, we expect to continue to launch new games in an accelerated piece -- pace. Next, I would like to talk about our progress in our AI-powered hardware business. As stated in the past, our AI-powered smart device business had been jointly developed by Beijing OrionStar. Cheetah Mobile has about 34% equity in Beijing OrionStar and has a 2-year warrant to gain more equity interest to achieve a controlling position. We hope to leverage Cheetah Mobile's expertise in customer-driving products under the AI compatibilities of Beijing OrionStar to create a more and more smart device. For example, we have released a voice interactive AI speaker called Cheetah Voicepod in March.

In July, we released an AI interpretation device called Cheetah Translator at affordable price of about USD 40.

Our existing -- our users will communicate with the foreign language speakers. The Cheetah Translator has a super user-friendly one pattern design that automatically identify language being spoken and translated into talking language.

Currently, the Cheetah Translator support 4 languages English, Chinese, Japanese and the Korean. Customers can buy Cheetah Translators on multiple e-commerce platforms such as JD.com and Tmall.com. Cheetah Translator has been very well received by the market making it as a best seller among its peer products.

Although the sales from Cheetah Voicepod and the Cheetah Translator today are still insignificant compared to our -- to the overall revenue of Cheetah Mobile. We believe these are important steps for us to develop and enhance our AI-powered smart device business. With that, I will now turn the call to our CFO, Vincent Jiang for Q2 business and the financial updates.

Zhenyu Jiang - Cheetah Mobile Inc. - CFO

Thank you, Sheng Fu. Hello, everyone. Now let me walk you through the details of our second quarter performance. All financial numbers are in RMB unless otherwise noted.

We achieved better-than-expected financial performances during the second quarter, as we are executing our strategy of rejuvenating our revenue growth and expanding our profitability for the remainder of 2018.

Total revenues for the second quarter of 2018 were RMB 1.10 billion, exceeding our previous guidance range of RMB 1.02 billion to RMB 1.08 billion.

Gross profit increased by 2% to RMB 752 million in the second quarter of 2018.

Gross margin expanded to 68% from 63% in the same period last year. Operating profits increased to RMB 128 million from RMB 66 million in the same period last year.

Operating margin expanded to 12% from 6% in the same period last year.

In Q2, we reported a diluted income per ADS of \$1.29 up from \$0.47 in the same period last year.

Net income attributable to Cheetah Mobile shareholders for the second quarter of 2018 increased by 180% year-over-year and 181% quarter-over-quarter to RMB 197 million.

The increase in our profits were mostly due to 3 factors: first, the disposal of the loss-making business, News Republic, in 2017; second, our efforts in optimizing the cost structure of our utility products and related services business; and last, increases in fair value of certain of our long-term investments. One such investment is Coding Cat or (foreign language) in Chinese, which is a Chinese online education platform that teaches students how to code computer programs.

As of June 30, 2018, our cash, cash equivalents and restricted cash and short-term investments were RMB 3.52 billion, our strong cash position has allowed us to continue our investments in the AI-powered business, which is an integral component of our long-term growth strategy.

Moving on to the details in each of our reporting segments. Note that starting on January 1, 2018, Cheetah Mobile adopted ASC 606, the new accounting standards for net value added tax out of line items on revenues and cost of revenues.

To increase comparability with the second quarter 2018 numbers, we have adjusted our 2017 revenue number net of VAT.

For our utility products and related services business, revenues decreased by 5% year-over-year to RMB 756 million in the Q2 of 2018. The year-over-year decrease was due to: first, a decline in PC revenues as a result of the continued migration of Internet traffic from PC to mobile; second, the decline in revenues from mobile utility products in overseas markets. As we stated in the past, Facebook and Google have discontinued the placement of ads on mobile phone lock screens since May 2017 and January 2018, respectively, which in turn reduced our ad inventory.

We have made up some of the lost revenues by creating new and innovative monetization approaches within our apps. More importantly, the strong performance of our mobile utility products in China has largely offset the weakness in the overseas markets. The strength in the domestic market was mainly due to a year-over-year increase in our ad impressions driven by the expansion of our user base in China as well as the elevation of our user engagement levels.

In June, the DAU of Clean Master in China exceeded the 30 million mark for the first time ever. Clean Master remains the top cleaning app in China according to iResearch.

During the second quarter, we also expanded our advertisement base, primarily by working with more mobile advertisement platforms such as Xiaomi and Toutiao. This initiative allowed us to increase our eCPM on a year-over-year basis.

Despite a year-over-year revenue decrease in our utility products and related services business, we continue to grow our profit and expand our margins. Our ongoing efforts in optimizing our cost structures combined with a revenue increase from our utility products in China, drove our profit margin expansion. In the second quarter of 2018, noncash operating profits for our utility products and related services increased by 33% year-over-year to RMB 282 million. In non-GAAP operating margin for our utility products and related services expanded to 37% up from 27% in the same period last year.

For our mobile entertainment business, revenues decreased by 10% year-over-year to RMB 333 million in the second quarter of 2018, mainly as a result of a 9% reduction in revenues from our mobile games business. The revenue decline in mobile games was mostly due to a temporary void in the new titles.

However, our existing game portfolio has continued to achieve solid performance, and we expect our mobile game business in the third quarter will resume sequential growth. Summertime is always a high season for our mobile game business, and we have seen a few of our new games are gaining momentum in the third quarter.

Revenues from our content-driven products decreased by 11% year-over-year to RMB 194 million in the second quarter of 2018. The decrease was largely due to the disposal of the News Republic application in the first quarter of 2017 as well as a slight decline in revenues from Live.me, which is the result of continued depreciation of U.S. dollar against RMB in the second quarter of 2018.

Our non-GAAP operating losses for the mobile entertainment business narrowed to RMB 99 million in the quarter from RMB 122 million in the same period last year. The reduced losses were primarily attributable to the reduced costs and expenses from the News Republic business, as we disposed off News Republic in Q4 2017.

Looking ahead into the third quarter, we currently estimate total revenues for the third quarter to between RMB 1.29 billion to RMB 1.35 billion, representing a year-over-year increase of 10% to 15%. We expect our mobile game business in our mobile utility products and related services

business in the domestic market to be the main growth drivers. Please note that this forecast reflects the company's current and preliminary view and is subject to change. This concludes our prepared remarks. Operator, we are now ready to take questions. Thank you.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And the first question comes from Wendy Huang with Macquarie.

Wendy Huang - Macquarie Research - Head of Asian Internet and Media

Just on -- can you give some color about your Q3 guidance, you've suggested very strong assumption of your growth and what's the driver behind it? And also, secondly, you mentioned about your collaboration with Xiaomi and Toutiao that started in second quarter. Can you give more color about renminbi contribution from this new collaboration and also how do you expect to trend up in the second half. Lastly, on the margin trend, so this quarter the gross margin came much greater than expected. What's the reason behind it and how should we expect the margins in the second half as well?

Helen Jing Zhu

Okay, Wendy, just hold on a second.

Wendy Huang - Macquarie Research - Head of Asian Internet and Media

Sure.

Zhenyu Jiang - Cheetah Mobile Inc. - CFO

Wendy, let me take the first question about the assumption behind the growth drivers. Actually there are 2 -- there will be 2 main growth drivers for the company in the second half. First of all is the mobile entertainment -- excuse me, is the mobile utility products within domestic markets. Since starting Q3 last year, we have seen significant growth in the domestic markets for the utility products, because of 2 reasons: first reason is that the user engagement level has been increasing, because we have made quite a significant improvement in the products itself. And we also see our users growing because of that effect, also because of we are doing more marketing within China, because we are paying more attention to the domestic market now. And also the reason for the growth in the domestic market is, we are adding new advertisers, basically we are diversifying our advertisers base including the relatively new companies such as Internet company like the short videos -- shorter video producers, the -- and news portals for example. And so that's the first driver; and the second driver is the mobile game business. Although we have declining revenues from our mobile games in second quarter, but we are making a significant increase in terms of the number of games we are able to launch in the second quarter. We actually -- initially we expected that we will have more games in the second quarter to be launched, but because of some delays, we were not able to do that in the second quarter, but those games had been launched in Q2 -- the end of Q2. So right now, it's third quarter now. We have seen some encouraging news in the third quarter, especially in September -- excuse me, in July and August, because the summertime is a high season for us for the games. Well, that answers the first part.

Sheng Fu - Cheetah Mobile Inc. - Chairman of the Board & CEO

(foreign language)



Zhenyu Jiang - Cheetah Mobile Inc. - CFO

Okay, the second part.

Sheng Fu - Cheetah Mobile Inc. - Chairman of the Board & CEO

(foreign language)

Zhenyu Jiang - Cheetah Mobile Inc. - CFO

Well, for -- with -- the corporation with Xiaomi and Toutiao, I think there's 2 parts: first of all, we are expanding our user acquisition channels and Toutiao and Xiaomi are 2 very effective channels for our -- for us to acquire new users; and secondly, we are adding SDKs and receiving advertise placements from these 2 platforms, which in a way that increased our ad supplies.

Wendy Huang - Macquarie Research - Head of Asian Internet and Media

And can you give some color regarding the revenue related to Xiaomi and Toutiao?

Zhenyu Jiang - Cheetah Mobile Inc. - CFO

Well, in terms of the revenue contribution from Xiaomi and Toutiao, its relatively small actually. So the contribution, it's 2 ways. First of all, we were able to work with them to acquire more users, actually this is a more significant part in terms of revenue contribution.

Wendy Huang - Macquarie Research - Head of Asian Internet and Media

Sure. So how about the margin?

Zhenyu Jiang - Cheetah Mobile Inc. - CFO

We expect our margin will -- actually will continue to improve. A couple of reasons: first -- okay, I'll continue. I'm sorry...

Wendy Huang - Macquarie Research - Head of Asian Internet and Media

Yes sure. Can you give us some color on the better-than-expected margin in the second quarter and also the reason behind the clear margin improvements in the second half in (inaudible).

Zhenyu Jiang - Cheetah Mobile Inc. - CFO

Well, in terms of the margin expansion, first of all, we have the -- and you look at the cost of the revenues, we have the -- okay, for the cost of revenues, we have discontinued certain old products, for example, one of them is the online call, this is some product, which doesn't have good margins, we discontinued these products. And also for the IDC and CDM products, because of the decrease in terms of the inventory, ad inventory. So that comes naturally with the reduction of cost associated with the decrease in ad inventory. And also for the sales and marketing, we are adjusting our sales and marketing expenses. For example, we are decreasing the sales and marketing expenses in developing countries, which helps reduce the -- because the revenue contribution from those markets are relatively less -- relatively small, so reduction in those markets actually helps to contribute to our margin improvement. Also another reason is actually because of R&D expenses, which is much smaller than previous years. One reason for the reduced R&D expenses was that, first of all, we granted more options and equity awards in early years than in 2018. And



secondly, because of we're using accelerated method to account the expenses -- share-based compensation expenses for that -- for those awards. And naturally, there will be more sales -- more share-based compensation expenses in early years than the ones we incurred this year. So those are the main reasons.

Operator

(Operator Instructions) The next question comes from Thomas Chong with Crédit Suisse.

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

I have 2 questions. The first question is about the mobile games market outlook in China given there are -- given regulatory concerns, and how we ensure our mobile games can have strong growth in the second half? And my second question is about the competition of Clean Master in China, who are our competitors on utility products? (foreign language)

Sheng Fu - *Cheetah Mobile Inc. - Chairman of the Board & CEO*

(foreign language)

Zhenyu Jiang - *Cheetah Mobile Inc. - CFO*

Okay. So the casual games business for us in China actually is growing pretty good. For example, Piano Tiles 2 and Dancing Line, which are the 2-hour -- 12-hour mature casual games, which was in overseas market, but now they are developing in China with -- in a pretty good way, actually a lot of users are using it. But of course, because of the recent regulations, because new games cannot get a copyright and they cannot be officially released, which will impact the long-term new games in China.

Sheng Fu - *Cheetah Mobile Inc. - Chairman of the Board & CEO*

(foreign language)

Zhenyu Jiang - *Cheetah Mobile Inc. - CFO*

Okay. For the more complex games, the competition is extremely competitive right now in China. But for Cheetah Mobile, we are using casual games, we are have casual games and which actually give us a lot of advantages, because for many overseas well-known brands or well-known games and also for -- some other more globalized IP contents, Cheetah Mobile does have its own advantages in China.

Sheng Fu - *Cheetah Mobile Inc. - Chairman of the Board & CEO*

(foreign language)

Zhenyu Jiang - *Cheetah Mobile Inc. - CFO*

Okay. In the past, we had some difficulties to develop in-game features for us, but fortunately, we have made some breakthroughs in the in-game purchase features. So we think that we do have a lot of opportunities in the future.



Sheng Fu - Cheetah Mobile Inc. - Chairman of the Board & CEO

(foreign language)

Zhenyu Jiang - Cheetah Mobile Inc. - CFO

Okay. In China, many cell phone makers do have their own phone management tools. For example, Tencent has their own management tools and those are all Cheetah Mobile's Clean Master's competitors.

Sheng Fu - Cheetah Mobile Inc. - Chairman of the Board & CEO

(foreign language)

Zhenyu Jiang - Cheetah Mobile Inc. - CFO

Okay. That's the answer to your questions.

Operator

And the next question comes from Robert Cowell with 86Research.

Robert W. Cowell - 86Research Limited - Analyst

I actually have 2. The first one is about your cash balance. I know that you have quite a bit of cash on the balance sheet. So I'm interested, you have -- strategically how do you all think about that cash and what do you plan to do with it? And then my second question is about your AI initiatives and maybe 2 aspects. One is on the AI voice operating system, I noticed you have quite a high market share in the Chinese market. I'm wondering if there's any plan or avenue to monetize that market share? And then second is on the warrant, how do you all think about converting those warrants? And when can we expect that business to start hitting the P&L? I'll try and translate into Chinese (foreign language)

Zhenyu Jiang - Cheetah Mobile Inc. - CFO

Robert, let me take the first question. For the cash on our balance sheet, we are continuing to look for strategic opportunities. We have done a few acquisitions in the past and we will continue to do so -- we expect to continue to do so in the future, but we will be very careful, very prudent. We have to make sure that opportunity is there before we make any bigger decisions. And secondly, we are making some smaller long-term investments from time-to-time. As you can see we have more than RMB 1 billion worth of long-term investments on our balance sheet. And we are continuing to making smaller investments for -- especially in these areas that do have potential synergies with Cheetah Mobile's core business including the online advertising or AI-related products and services.

Sheng Fu - Cheetah Mobile Inc. - Chairman of the Board & CEO

(foreign language)

Zhenyu Jiang - Cheetah Mobile Inc. - CFO

Okay. Yes, indeed. The voice interactive operating system developed by OrionStar has quite significant market shares. For example, Cheetah Mobile's smart speaker, also -- and other manufacturers of smart speakers such as Midi, Himalaya and Xiaomi all use Cheetah OrionStar's voice interactive

system, actually for the Xiaomi, part of those -- part of their products use OrionStar's voice interactive operating system. For Xiao Ai, which is also the smart speaker developed by Xiaomi, the text-to-speech module is developed by OrionStar. But in terms of the monetization, we think it is still in relatively early stage for the entire industry to monetize. We are -- still find a way to effectively to generate revenue from the operating systems. We think that voice interactive system or smart speakers, it's a new category actually, and it can be the entry point for people to access Internet and depending on the time spent with the AI speaker and the number of users for the AI speaker, we think there's opportunity. But in terms of now, we -- actually we don't have huge amount of monetization, have been achieved by anyone in this industry.

Sheng Fu - Cheetah Mobile Inc. - Chairman of the Board & CEO

(foreign language)

Zhenyu Jiang - Cheetah Mobile Inc. - CFO

Okay. The second possibility is our, we call it (inaudible) Xiaomi, which is a greet box. It's kind of a receptionist function as a receptionist for business in some commercial -- excuse me, for some commercial settings. We think there's good opportunities to monetize, because we do have won some awards recently for the greet box.

Sheng Fu - Cheetah Mobile Inc. - Chairman of the Board & CEO

(foreign language)

Zhenyu Jiang - Cheetah Mobile Inc. - CFO

Well, right. For the warrants to purchase additional equity stake in OrionStar, which is a decision to be made by the Board of Cheetah Mobile, so that cannot be answered in this call.

Robert W. Cowell - 86Research Limited - Analyst

Could you remind us when is the deadline for exercise of the warrants?

Zhenyu Jiang - Cheetah Mobile Inc. - CFO

I think we still have little more than 1 year.

Robert W. Cowell - 86Research Limited - Analyst

Okay, little over a year, right.

Operator

And as there are no more questions at the present time, I would like to return the call to management for any closing comments.

Helen Jing Zhu

Thank you all for joining us today. If you have any further questions, please do not hesitate to contact us. Thank you. Bye.



Operator

Thank you. The conference has now concluded. Thank you for attending today's presentation. You may now disconnect your lines.

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