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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to Sogou's Third 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 call over to your host today, Jessie Zheng, Investor Relations, Director of Sogou. Please go ahead.

Jessie Zheng - *Sogou Inc. - IR Director*

Hello, everyone, and thank you for joining Sogou's Third Quarter 2018 Conference Call. On the call, our CEO, Xiaochuan Wang; and our CFO, Joe Zhou, will give an overview of operations and the financial results.

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 the 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 statements. For more information about the potential risks and uncertainties, please refer to the company's filings with the Securities and Exchange Commission.

With that, I will now turn the call over to our CEO, Xiaochuan Wang.

Xiaochuan Wang - *Sogou Inc. - CEO & Director*

Thank you, Jessie. During the third quarter of 2018, we recorded healthy business growth. As the second largest search engine by mobile search queries in China, we continued to grow our core search revenues faster than the industry average. Sogou Mobile Keyboard cemented its leading position with 405 million DAUs, up 32% year-over-year. According to iResearch, Sogou Mobile Keyboard remains the third largest mobile application in China by DAU. We remained focused on executing our strategy to differentiate our offerings and enhance competitiveness. We also continued to apply our AI capabilities to all business segments to upgrade our products and the services, and towards the next phase of growth.

Now I will provide an update on the key initiatives in our core businesses, starting with search. Thanks to our differentiated content capacity and leading Q&A technology. All operating indicators in our search business steadily improved in the third quarter. We continued to enrich our platform with high-quality authoritative health care content to further differentiate our services from here.



At present, we partnered with the leading medical information platform and the Chinese pharmaceutical information platform, that both directly administrated by China's National Health and Family Planning Commission. Through this partnership, we can provide users with comprehensive information about diseases, symptoms and drugs. We have also integrated a vast amount of interactive Q&A content from replicable softwares into our health care search results. As a result of this initiative, content from authoritative service now comprises 65% of Sogou's health care search results, significantly higher than our competitors. Our efforts to provide users with reliable trustworthy health care information to over 36% year-over-year increase in mobile health care search queries in the quarter.

At the same time, we continued to leverage our independently-developed Q&A technology to upgrade our search services. This significantly improved user satisfaction of our talk direct on the results to search queries. In the third quarter, we processed 38% of our total search queries with search results with 94% accuracy rate.

We also continued to optimize search results by increasing the display of images and videos and build the growing database of authoritative content for health care and other verticals. With these efforts, users are now more likely to first seek on Sogou's top results. Among all the search results on our platform is that proportion growing from 25% to 32% quarter-on-quarter.

Moving on to Sogou Mobile Keyboard. We continued to leverage AI technologies to drive innovation and provide more intelligent user interaction and its presence. This enabled us to realize solid growth in both our user base and market share. In the third quarter, we fully upgraded our speech recognition model, reducing the error risk for Chinese speech recognition by more than 20%, and that of Chinese, English mix of speech recognition by more than 50%. By the end of September 2018, Sogou Mobile Keyboard processed up to 500 million daily voice requests, making it to the largest voice app in China.

We also optimized our smart reply function for chat by leveraging our independently developed dialogue algorithm to provide users with more diverse, interesting and personalized responses. In addition, the improved integration of Sogou Mobile Keyboard and Sogou Search and to launch recommendation services to meet users' needs in real time. For example, if users talk about the weather, our mobile keyboard do recommend content such as weather forecast.

In terms of smart hardware, we continued to implement our upgraded strategy in the third quarter, replaced out the updated version of the Teemo Smart Watch with less integrated AI capabilities. We also shifted our R&D and sales capabilities to new products and better utilize our core AI competencies. This -- that key decision will have a short-term impact on our smart hardware sales in the second half of this year. But we believe that in the mid to long run, this will help us to establish a more competitive position in the market.

Only 6 months after the launch of the Sogou Travel Translator, we launched the Sogou Translator Pro in September 2018. In addition to 2018 travel, the pro edition can be used for business occasions, English language learnings, sporting events and more. The Sogou Translator product called AI capabilities, including of live translation are significantly better than competing products. This has led to a significant improvement in user recognition, indicating we are headed in the right direction with our strategy upgrades.

Turning to AI. We continued to implement our strategy of developing language-centric technologies that advance natural human machine interaction and the knowledge computing. We are increasing our R&D investments to develop core AI technologies. We are also applying these technologies in a range of user cases based on our own product portfolio. And in turn, we are leveraging the massive amount of data we generated to put that into the AI technology development process. Through our long-term commitment to AI, we have developed competitive strength in core technologies, such as voice, computer vision, machine translation and Q&A, and we continued to leverage these technologies to empower our core businesses.

During the quarter, we made this significant progress with some our core technologies. We updated our speech recognition model, improving the accuracy of speech recognition for Chinese, English, Japanese and Korean; and decreasing the error rates by as much as 50% in some languages. Moreover, our leading deep learning-based computer vision technology was recognized at top-tier international competition. For example, we received first place in the top category of object detection at PASCAL VOC. A prominent global challenge for computer vision held in September 2018. We also continued to explore ways to apply our AI technology in commercial settings. Just a few weeks ago, Sogou provided AI-powered machine simultaneous interpretation at the China Open Tennis Championship. This marked the first time that AI-enabled real-time interpretation



technology was used at an international sporting event. More importantly, Sogou Search, Sogou Mobile Keyboard and our smart hardware products have become more competitive in their respective markets, as we apply AI across all our businesses.

Lastly, in September 2018, we renewed our framework agreement for our business collaboration with Tencent. Over the next 5 years, Sogou Search will remain the default search tool for a range of Tencent products. And for the first time, our cooperation with WeChat was officially covered in the renewed Tencent agreement. Over the next year, Sogou Search has been designated the preferred search engine for third-party search services to access external Internet content.

Both Tencent and Sogou intend to expand this cooperation over the next 5 years on an annual basis. The renewed agreement demonstrates that Sogou and Tencent are working together on their shared commitment to provide users with the best search experience.

That concludes my prepared part. Now I'd like to make a special announcement that remarks you just heard for (inaudible) using personalized speech synthesis and (inaudible) transfer learning technology, which is developed by the Sogou voice interaction technology center. Once you include Chinese for English test, the technology can stimulate a person's voice in his or her style. This is probably the first time globally that speech synthesis technology has been used on an earnings conference call.

Now I'd like to (inaudible) to say a few words.

Unidentified Company Representative

Hello, everyone. This is me in person. I'm very pleased to demonstrate the cutting-edge technologies that we have been developing at the Sogou voice interacting technology center. This is just one of the potential applications of this technology.

Now I will turn the call over to Joe, the real person, who will walk you through our financials.

Yi Zhou - Sogou Inc. - CFO

Thank you, (inaudible). Hello, everyone. Third quarter revenues reached \$277 million, which was in line with our prior guidance. There was a onetime adverse impact from the 10-day suspension of a portion of our advertising services in early July, in order to implement remedial measures to ensure compliance with government regulations. Even with that in the backdrop, on a constant currency basis, our core search revenues would have booked a 16% increase year-over-year, continually outgrowing the industry average. Our non-GAAP net income was \$28 million. During the quarter, we made solid progress in integrating our twin growth engines, Sogou Search and Sogou Mobile Keyboard, which started to bring incremental organic traffic. We also invested in advancing core AI capabilities as well as smart hardware upgrade. Going forward, we will continue to execute on the twin engine strategy to generate sustainable growth in our core businesses.

Now I'll walk you through our financials. Please note that unless otherwise noted, all monetary amounts that I discuss are in U.S. dollars. Also know that I will refer to some non-GAAP numbers, which exclude share-based compensation expenses. You can find our reconciliation of non-GAAP to GAAP measures in our earnings release.

As I noted earlier, total revenues in the third quarter were \$277 million, a 7% increase year-over-year. On a constant currency basis, total revenues in the third quarter would have been \$283 million, a 10% increase year-over-year.

Search and search-related revenues were \$255 million, a 13% increase year-over-year. On a constant currency basis, search and search-related revenues would have booked a 16% increase year-over-year. The increase was primarily due to growth in auction-based pay-for-click services, driven by improved monetization and continued traffic growth in mobile search. As I mentioned earlier, this incorporates the onetime adverse impact from the 10-day suspension of a portion of our advertising practices in early July.



Auction-based pay-for-click services accounted for 83% of our search and search-related revenues compared to 84% in the corresponding period. The number of advertisers of our auction-based pay-for-click service was approximately 81,000. The average revenue per advertiser for auction-based pay-for-click services was \$2,600.

Other revenues were \$21 million, a 33% decrease year-over-year. The decrease was primarily due to lower sales of smart hardware products, following the decision to upgrade our smart hardware strategy to better leverage our AI capabilities and improve our product competitiveness.

Cost of revenues was \$174 million, a 33% increase year-over-year. Traffic acquisition cost, a primary driver of cost of revenues, was \$135 million, a 58% increase year-over-year, representing 49% of total revenues compared to 33% in the corresponding period. The year-over-year increase was driven by price inflation as a result of increased competition. In addition to our efforts to increase organic traffic, we will continue to expand our traffic acquisition to steadily grow our total search traffic. Both GAAP and the non-GAAP gross profit were \$103 million, a 19% decrease year-over-year. Both GAAP and the non-GAAP gross margins were 37% compared with 49% a year ago. The decrease primarily resulted from traffic acquisition cost outgrowing revenues.

Total operating expenses were \$110 million, a 20% increase year-over-year. Research and development expenses were \$51 million, a 26% increase year-over-year, representing 18% of total revenues compared to 16% in the corresponding period in 2017. The increase was primarily due to an increase in salary and benefits expenses as well as share-based compensation expense, reflecting our continued efforts to strengthen our AI capabilities.

Sales and marketing expenses were \$54 million -- \$44 million, a 3% decrease year-over-year, representing 16% of total revenues compared to 17% in the corresponding period in 2017. The decrease was primarily attributable to a decrease in marketing and in promotional spending for some of our mobile products.

G&A expenses were \$16 million, a 149% increase year-over-year, representing 6% of total revenues compared to 2% in the corresponding period in 2017. The increase was primarily due to a provision for loan losses as we expanded more consumer loans through our Internet finance platform as well as an increase in inventory impairment loss of smart hardware products.

Operating loss was \$7 million compared to operating income of \$36 million in the same period last year. Non-GAAP operating loss was \$3 million compared to an income of \$36 million in the same period last year.

Other income net was \$24 million compared with approximately 0 in the corresponding period in 2017. The increase was primarily due to an \$18 million gain from one of our equity investments. This was recognized under the new accounting standard that changes the way companies account for equity investments.

Income tax benefit was \$0.4 million compared to income tax expense of \$5 million in the corresponding quarter of 2017. The income tax benefit resulted from a new tax incentive to encourage R&D investments. Under new PRC regulations issued in September and applicable retroactively beginning January 1, more R&D expenses become eligible for further deduction from taxable income.

Net income attributable to Sogou was \$24 million, a 23% decrease year-over-year. Non-GAAP net income attributable to Sogou was \$28 million, a 10% decrease year-over-year.

Basic earnings per ADS and diluted earnings per ADS were \$0.06. Non-GAAP basic and diluted earnings per ADS were \$0.07. As of September 30, we had cash and cash equivalents and short-term investments of \$1.1 billion compared with \$1 billion as of December 31, 2017.

Net operating cash inflow for the third quarter of 2018 was \$85 million. Capital expenditures for the third quarter of 2018 were \$22 million. We believe with strong balance sheet and positive operating cash flow, we are well positioned to continue to invest in technologies and talent to grow our business.

And finally, turning to guidance. For the first quarter of 2018, we expect the total revenues to be in the range of \$292 million to \$307 million, representing a 5% to 11% increase year-over-year or 11% to 17% increase year-over-year in RMB terms.

The guidance takes into account a year-over-year decrease in other revenues due to the upgrade of our smart hardware strategy, some macro uncertainties and regulatory headwind for certain sectors. Please note that for the fourth quarter 2018 guidance, we have presumed an exchange rate of RMB 7 to the dollar as compared with the actual exchange rate of approximately RMB 6.61 to the dollar for the first quarter of 2017, and RMB 6.81 to the dollar for the third quarter of 2018.

That concludes our prepared remarks.

Jessie Zheng - Sogou Inc. - IR Director

Thank you, Joe. Operator, we now like to open the call for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from Thomas Chong of Crédit Suisse.

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

I have 2 questions. The first question is about 2019 outlook. How should we think about the impact on macro headwinds and regulations? And my second question is about our IoT strategies for next year, given our smart hardware revenue should be covered in 2019?

Xiaochuan Wang - Sogou Inc. - CEO & Director

(foreign language)

Jessie Zheng - Sogou Inc. - IR Director

So apparently, we're seeing some economic slowdown in China. And we doubt that advertisers are turning cautious on budget allocation. But our search advertising has maintained steady growth, and it's truly resilient given the unfavorable economic trends. When the economy slows down, advertisers pay more attention to ROI. So search adds our performance-based advertising and ROI is much more transparent. So we believe that search advertising is impacted to smaller extent.

Xiaochuan Wang - Sogou Inc. - CEO & Director

(foreign language)

Jessie Zheng - Sogou Inc. - IR Director

On smart hardware, I think our strategy has been that we need to leverage those technologies in voice, computer vision, machine translation and Q&A, along the roadmap of natural interaction and knowledge computing, and integrate such AI technology closely with smart hardware to help strengthen Sogou's competitiveness and differentiation. In the first half and more recently, we launched a series of translation devices that help



us showcase our AI capabilities and build a stronger brand in the market. And in the future, we look to launch some products that are of more strategic implications, that are designed to serve as a better gateway for user interaction. So for next year, we look to double sales in smart hardware.

Operator

Our next question comes from Bill Liu of Goldman Sachs.

Chong Liu - *Goldman Sachs Group Inc., Research Division - Associate*

I have a question about our traffic mix. I understand that our organic search traffic should grow the fastest as it is before. But I wonder, with the decline in shipment of smartphone and other smart devices, do we expect the purchase traffic to actually may decline on an absolute basis? And how that mix will change going forward?

Yi Zhou - *Sogou Inc. - CFO*

So first, I want to give you more background information on the traffic mix. So this quarter, organic traffic accounts for 26% of our total traffic, while Tencent channel contribute roughly [77%] and whereas OEM handset maker channel contribute 37% for the -- of the rise. The slowdown of Tencent sales, I think, it doesn't directly affect the search traffic because the mobile phone users that doesn't decrease. So that will not affect the traffic acquisition. We will continue to improve our monetization capability, and we will continue to offer competitive price to compete and expand our traffic acquisition, so that we steadily grow our traffic.

Operator

Our next question comes from Xueru Zhang of 86Research.

Xueru Zhang - *86Research Limited - Analyst*

I have 2 questions. The first question is regarding partnership with Weixin. Can management share more color on the monetization progress? And when should we expect the traffic from Weixin and the revenue to become meaningful? And my second question is regarding to your AI initiatives. You have the AI-powered machine to simulation translation technology, which has applied at the China Open Tennis Championship, and now present your (inaudible) app technology and applied on the conference call. So I'm wondering will these become the search for Sogou to leverage your AI business -- or AI capability to enter the (inaudible) service market?

Xiaochuan Wang - *Sogou Inc. - CEO & Director*

(foreign language)

Jessie Zheng - *Sogou Inc. - IR Director*

So on WeChat search, we are still trying to optimize the search experience for users together with WeChat team. There is no time table for the monetization yet.

Xiaochuan Wang - *Sogou Inc. - CEO & Director*

(foreign language)



Jessie Zheng - Sogou Inc. - IR Director

So machine translation technology, for example, the simultaneous translation technology, we used for China Open, it's all based on natural language processing, actually highly related to search and mobile keyboard are 2 core products which basically are open users to communicate and get information. With the deep learning technology and translation technology getting more sophisticated, we think there is a chance for us to use search and mobile keyboard to communicate and get information globally for users. For example, in search, we have started to provide simultaneous translation, a machine translation to translate English content into Chinese globally. And such product initiatives are highly integrated with machine to communicate and make it easier to communicate and get information. So we are continuously invest in this area and other AI initiatives. We hope we can leverage these capabilities to upgrade our core products like search and mobile keyboard and also extend to the smart hardware business.

Operator

(Operator Instructions) Our next question will come from Alicia Yap of Citigroup.

Alicia Yap - Citigroup Inc, Research Division - MD and Head of Pan-Asia Internet Research

A couple of quick questions. Number one is that on your press release prepared remarks, you mentioned the very fast growth of the medical keywords query. So just wondered, if you can elaborate a little bit the reasons that contribute to this fast growth on the medical-related keywords? And second is that, if you can remind us what is the percentage of revenue contributions from the health care sector? And then just lastly, in terms of the overall macro, in light with some of these cautiousness, what are the advertising industry vertical that you think potentially could be more impacted that could also related to our revenue exposure that could also be impacted on this? So within different industry vertical, which one is more exposed to potential slowdown in the demand or the regulations impact?

Xiaochuan Wang - Sogou Inc. - CEO & Director

(foreign language)

Jessie Zheng - Sogou Inc. - IR Director

So on health care search, we are not intended to increase our advertising revenue from the health care vertical. We focus on providing the best natural results on health care information for users, and actually that will gradually lead to a relatively smaller percentage of advertising revenues from health care over time. On this initiative, we've increased our brand recognition and help us to increase our competitive in the search industry. So our strategy is to be build reliable, trustworthy health care search platform and that can help us grow our health care-related search queries. In the future, we'll continue to invest in professional content in health care and other verticals to increase the overall competitiveness of Sogou Search.

Yi Zhou - Sogou Inc. - CFO

Okay. I'll take the second question. So health care will actually contribute 20% of our total auction-based pay-for-click service revenue. Actually, it's our largest sector. After that, we have e-commerce, gaming, business services and the merchant services. Due to the uncertain macroeconomic, we see the overall slowdown for all the factors, not particular one.

Operator

(Operator Instructions) This concludes our question-and-answer session. I would like to turn the conference back over to Jessie Zheng for any closing remarks.



Jessie Zheng - Sogou Inc. - IR Director

Thank you, everyone, for joining today's call and for your continued support for Sogou. We look forward to speaking to you again in the future.

Operator

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

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