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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to Sogou's First Quarter 2019 Earnings Conference Call. (Operator Instructions) Today's conference call is being recorded, and 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 First Quarter 2019 Earnings Conference Call. On the call, our CEO, Xiaochuan Wang; and our CFO, Joe Zhou, will give an overview of the operations and financial results.

In line with our practice on the previous earnings conference call, Xiaochuan's prepared remarks will be made in his voice using personalized speech synthesis and style transfer learning technology, which was developed by the Sogou Voice Interaction Technology Center. Xiaochuan will join the Q&A portion of the call in person.

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 here, 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 statements.

For more information about 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, Jesse. During the first quarter of 2019, our core business recorded steady growth as we continued to execute our twin-engine strategy supported by Sogou Search and Sogou Mobile Keyboard. We also remain committed to leveraging our AI technologies to bolster innovation and enhance competitiveness across all business segments.

In search, we further differentiated our content offerings while driving ongoing upgrade of our services to intelligent Q&A-based research. As China's second largest search engine, our core search revenue maintained faster growth than industry average in the first quarter.

On Mobile Keyboard, we were pleased to see solid user traction in the first quarter. With increasing synergies with Sogou Search, the Mobile Keyboard now has stronger content and service distribution capabilities. At the end of March 2019, Sogou Mobile Keyboard has 443 million DAUs, an increase of 23% year-over-year. This positions us as the third largest Chinese mobile app in terms of DAU according to iResearch.

Now let me walk you through each of our core businesses, starting with search. As part of our strategy to build up more efficient and knowledgeable search platform that provides high-quality content, we focused our search efforts on the health care vertical and intelligence to unveil capabilities. In terms of health care search, in the first quarter, we further enriched our content ecosystem by integrating more interactive digital content to better address our user service.

We recently formed exclusive partnerships with several trusted institutions in the health care industry, which enabled us to provide more accurate search results and practical guidelines in multiple medical categories, including disease and maternal and infant care. Driven by this initiative, self-reviewed content accounted for much higher proportion of our health care search results compared to other industry players in the first quarter. At the same time, we further strengthened our intelligent Q&A capabilities that enable a more efficient search experience to users. During the first quarter, we continued to lead the industry in both the fulfillment and the accuracy of our top direct-answer results.

Turning to Mobile Keyboard. We are constantly integrating our latest AI technologies to launch more innovative product features. Our technologies in voice translation and dialogue have not only enabled more intelligent user interaction but also facilitated more personalized user expression, contributing to the solid growth of our user base.

By the end of March 2019, average daily voice requests made via Sogou Mobile Keyboard have increased by 69% year-over-year, way past 600 million requests per day, making Sogou Mobile Keyboard the largest voice app in China.

In addition, Sogou Mobile Keyboard has continuously strengthened its content and the service distribution capabilities. [Since driving best] understanding of user intent across multiple user cases, Sogou Mobile Keyboard now offers more targeted content recommendations in user chats. This has resulted in an increase in the click-through rate of the content as well as the rate that this content is shared between users.

Moving to smart hardware. In the first quarter, we leveraged our core AI capabilities to drive ongoing upgrades of this business segment. We have now established 3 major product lines: children, translation and voice. We also accelerated the product development process for our AI-enabled hardware product. In March, we launched our new smart recorder, C1. Integrating our latest AI competencies, the C1 has redefined the traditional micro-recorder with a variety of innovative functions, including real-time transcription and simultaneous translation into multiple languages. We believe it will transform the work style of a diverse group of users, such as journalists, students and businessmen and significantly improve work efficiency. To date, the C1 has been very positively received in the market.

In addition, we have stepped up our R&D of new products in the children and translation categories and are exploring the integration of multiple AI capabilities such as intelligent Q&A and Vocational Avatars, which will increase the competitiveness of our products.

Finally, turning to our AI strategy. We are committed to developing language-centric AI technologies that build our leadership position in voice, computer vision, machine translation and Q&A.

In the first quarter, we launched a new generation of Sogou Vocational Avatars that leverages our upgraded voice and computer vision technologies. Instead of a seated broadcaster, the new AI use news anchor is able to stand and gesture as a human broadcaster will, making its broadcast more

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natural and life-like. Following our launch of the world's first AI news anchor with Xinhua News Agency, they introduced their new female AI news anchor named Xin Xiaomeng, who made her debut during the Two Sessions.

We also launched another AI anchor jointly with CCTV finance channel to host the preview show for the March 15 consumer day gala. We just announced a partnership with Abu Dhabi Media company in the United Arab Emirates to provide a comprehensive AI news anchor solution. This marks the first time that our AI news anchor will be leveraged by an international media platform, and we look forward to introducing our solution to an even more global audience.

Now I will turn the call to Joe who will walk you through our financials.

Yi Zhou *- Sogou Inc. - CFO*

Thank you, Xiaochuan. Hello, everyone.

We are pleased to report that our total revenues exceeded the top end of our guidance in the first quarter of 2019. This result was primarily driven by the better-than-expected performance in our core search business with search and search-related revenues increasing by 13% year-over-year in RMB terms, a faster pace than the industry average. We will return to solid profitability in the second quarter with seasonal recovery and continuous growth of our organic traffic and improvement on monetization capability combined with a greater focus on execution and efficiency.

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

Total revenues in the first quarter were $253 million. On a constant currency basis, total revenues in the first quarter would have been $268 million, an 8% increase year-over-year. Search and search-related revenues were $234 million. On a constant currency basis, search and search-related revenues would have booked a 13% increase year-over-year. The increase was primarily due to the growth in auction-based pay-for-click services.

Auction-based pay-for-click services accounted for 87% of search and search-related revenues compared to 83% in the corresponding period in 2018. The number of advertisers for our auction-based pay-for-click service was approximately 79,400, up 7% year-over-year. The average revenue per advertiser for auction-based pay-for-click services was $2,600, up 7% year-over-year.

Other revenues were $19 million, a 34% decrease year-over-year. The decrease was primarily due to lower sales of smart hardware products as we continue to upgrade the smart hardware strategy and phase out certain legacy models of existing products with new models to be launched and increasing contribution from the newly launched smart recorder. We expect hardware sales to bottom out in the second quarter and to return to growth in the second half of 2019.

Cost of revenues were $185 million, a 20% increase year-over-year. Traffic acquisition costs, a primary driver of cost of revenues, was $143 million, a 28% increase year-over-year, representing 57% of total revenues compared to 45% in the corresponding period in 2018. The year-over-year increase was driven by price inflation, which has clearly moderated from a year ago. As we become more selective with traffic acquisition and benefit from expected increase in the contribution from organic traffic, we expect this type of growth to be contained for the remaining quarters of 2019.

Both GAAP and non-GAAP gross profit was $68 million compared to $94 million in the corresponding period in 2018. Both GAAP and non-GAAP gross margin were 27% compared to 38% a year ago. The decrease primarily resulted from the growth of traffic acquisition costs outpacing that of revenues.

Total operating expenses were $80 million, largely flat year-over-year. Research and development expenses were $41 million, a 12% decrease year-over-year, representing 16% of total revenues compared to 19% in the corresponding period in 2018. The decrease was primarily due to a decrease in personnel-related expenses.

Sales and marketing expenses were $29 million, an 8% increase year-over-year, representing 12% of total revenues compared to 11% in the corresponding period in 2018. The increase was primarily attributable to an increase in personnel-related expenses. G&A expenses were $10 million, a 53% increase year-over-year, representing 4% of total revenues compared to 3% in the corresponding period in 2018.

Operating loss was $12 million compared to an operating income of $14 million in the corresponding period in 2018. Non-GAAP operating loss was $11 million compared to non-GAAP operating income of $19 million in the corresponding period in 2018.

Other income, net was $9 million compared to $4 million in the corresponding period in 2018. The increase was primarily due to an increase in the gain from short-term investments. Income tax benefit was $0.2 million compared to income tax expense of $2 million in the corresponding period in 2018.

Net loss attributable to Sogou was $4 million compared to a net income of $15 million in the corresponding period in 2018. Non-GAAP net loss attributable to Sogou were $3 million compared to a net income of $20 million in the corresponding period in 2018. Basic and diluted loss per ADS were $0.01. Noncash basic and diluted loss per ADS were $0.01.

As of December 31, 2019, we had cash and cash equivalents and short-term investments of $1.1 billion compared to $1 billion as of December 31, 2018. Net operating cash inflow for the first quarter of 2019 was $92 million. Capital expenditures for the first quarter of 2019 were $9 million.

And finally, turning to guidance. For the second quarter of 2019, Sogou expects total revenues to be in the range of $303 million to $313 million, representing a 1% to 4% increase year-over-year or a 7% to 11% increase year-over-year in RMB terms.

Please note that for the second quarter 2019 guidance, we have assumed an exchange rate of RMB 6.80 to the dollar as compared with the actual exchange rate of approximately RMB 6.38 to the dollar for the second quarter of 2018 and RMB 6.74 to the dollar for the first quarter of 2019.

That concludes our prepared remarks.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Elsie Cheng of Goldman Sachs.

Haiwen Cheng - *Goldman Sachs Group Inc., Research Division - Research Analyst*

I have a question to Xiaochuan on the industry trend. So over the last 2 to 3 years, we actually have observed the seed platforms, whether it's new seed or short-video seeds, have added a lot of incremental ad inventory to the P4P advertising space, which results in a supply-demand dynamic change, and that's probably adding pricing pressure to the overall industry. So I'd like to hear your insights. Maybe first, what are your observations in the space? And how it has impacted the search vertical? And second, how do you think this dynamic will play out this year and also for the next few years? And finally, what's Sogou's strategy under the changing competitive dynamic? (foreign language)

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

(foreign language)

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Jessie Zheng - *Sogou Inc. - IR Director*

[Interpreted] So first, the [parent-led] seed is growing very fast, and I think it has a very big impact on advertising dollars. And admittedly, Sogou's share of that advertising budget is on the decline. However, since Sogou is a relatively smaller player and has a relatively small share of the market, we still have a lot of room for growth, whether it be seed or leveraging big data capabilities. We believe we will continue to outperform the search industry in terms of revenue growth.

Operator

(Operator Instructions) Our next question comes from Gregory Zhu of Crédit Suisse.

Cheng Zhu - *Crédit Suisse AG, Research Division - Research Analyst*

(foreign language) Now I'm translating my questions in English. As we noticed, the company has remarkably ramped up the monetization pace compared to the classics. We -- can we know what are the triggers contribute to this significant increase? And more specifically, can we understand how should we put AI technology into this development? My -- our second question is regarding the smart hardware. Can management further explain what is the synergy between the AI smart hardware versus the current search and keyboard business?

Yi Zhou - *Sogou Inc. - CFO*

Okay. So I'll take the first one. First, I'll give you more detail on the basic data. So for Q1, in RMB terms, our total revenue increased 80%, and our [run ad] search-related revenue increased 13%. So among the 13% growth, roughly close to 10% is from the improvement on monetization, and the rest due to the growth in traffic. So why we can have a better improvement on monetization than the industry average? So basically, there are 2 factors: Number one, comparing to the industry leader, in terms of RPM, we still have certain gap with them, so -- especially on the mobile side. So that's why we still have a lot of room to improve. And the second reason, last year, due to the (inaudible) third quarter, that caused the management team, especially the monetization team, a lot of effort and time to [cope with that instance.] After that -- I mean in the Q4 last year and this Q1, they shifted their focus on the improvement on monetization. That's why we see a much faster improvement on monetization in Q1, and this trend will continue into second quarter and the second half of 2019.

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

(foreign language)

Jessie Zheng - *Sogou Inc. - IR Director*

[Interpreted] Okay. Regarding your second question on synergies among search, keyboard and hardware, we viewed our business in certain key roles based on language-centric capabilities. And with the era of artificial intelligence, we've developed a road map of natural interaction and knowledge computing. And we used such technologies into our search and Mobile Keyboard. For example, using our natural interaction, we enabled our Mobile Keyboard to become the largest voice app in China, and using knowledge computing, it can actually automatically, intelligently reply to users in user chats. And similarly, in search, by leveraging AI capabilities, we've been able to transition search over time to Q&A-based -- intelligent Q&A-based search. And also, in terms of hardware, we are trying to leverage language-centric capabilities into the development process of our hardware business to help users to better input, express themselves and get information. For example, in our latest launch of the smart recorder, C1, we've leveraged a lot of language capabilities and then make it a very efficient experience for a diverse group of users. And in the future, we plan to launch a few more new AI-enabled hardware product that would more closely integrate our language-centric AI capabilities.

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Operator

Our next question comes from Xueru Zhang of 86Research.

Xueru Zhang - *86Research Limited - Analyst*

(foreign language) The first question is, can management comment about how we see the advertising sentiment changing from Q1 to Q2? Please tell me. And how should we think about the trend for our key advertising categories as we head into 2019? And then a follow-up question on AI-related exploration. I'm wondering, besides the smart hardware business and the other monetization opportunities here, which could leverage your core competence, in particular your speech and translation, that we should pay attention to.

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

(foreign language)

Jessie Zheng - *Sogou Inc. - IR Director*

[Interpreted] So regarding your first question on advertising sentiment, we believe Sogou has a relatively small base of advertisers, and we may not be the best representative to speak for the industry. Having said that, you may notice that our advertising revenues grew by 13% in the first quarter. And actually, we are in the process of signing up a framework contract with key accounts, and we currently see a 15% to 20% growth. So that shows that our search -- core search business is having a solid growth.

The top 5 sectors are still health care, e-commerce, gaming, merchant services and business services. In the first quarter, we haven't seen much change from the advertiser spend. It varies according to different sectors, but not so much, more or less affected by the macro softness. And some specific industries like gaming is more impacted by regulatory.

In addition to leveraging our AI capabilities in smart hardware business, I've just mentioned we've been able to apply search competencies in our keyboard and -- which help users to communicate and get information. We believe with the refinement of our language-centric capabilities, such as voice interaction, computer vision and the Q&A technologies, I think keyboard has greater room for growth.

On the [2B] side, we've also noticed some opportunities, although we would not take a full swing into that. But we -- our AI news anchor actually has been well received in the market. And actually, in different sectors, it has a potential application such as education, insurance, news reporting, which allows us to leverage such AI news anchor solutions to help them better communicate with their target audience.

Operator

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

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

(foreign language) I have 2 quick questions. Number one is that, given Sogou recently had some progress on the news feed, whether management could elaborate a little bit some of the achievement. And also, any plans to enter the short video content? And then second question is that, given there is a lot more step-up or a little bit sensitive year this year, so have you seen any step-up content control from the regulatory side? If so, any potential impact that you foresee that it could affect the search industry and also Sogou?

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

(foreign language)

Jessie Zheng - *Sogou Inc. - IR Director*

[Interpreted] On the short video, I think we are trying to develop our own content ecosystem, including [Sogou Hao]. It's similar to [Tudou Hao]. And this has been driving the growth of seed and search content. We are not going to enter in the market of YouTube content on the short video front but we have been working with some short video companies like Kuaishou to improve the [coverage of] short-video content on our search platform.

On the regulatory control, we've seen that since the second half of last year, regulators have stepped up their regulation on the Internet industry. We are coping well with our related agencies to meet their demand, but we haven't seen a further step up of their regulatory control. We don't expect any more regulatory risks going forward.

Operator

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*

Okay. Thank you all for attending Sogou's first quarter earnings conference call. We look forward to speaking to you next time.

Operator

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