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ZTO.N - Q1 2019 ZTO Express (Cayman) Inc Earnings Call

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PRESENTATION

Operator

Good evening, and welcome to the ZTO First Quarter 2019 Earnings Conference Call. (Operator Instructions) Please note this event is being recorded.

I would now like to turn the conference over to Ms. Sophie Li. Please go ahead.

Sophie Li - *ZTO Express (Cayman) Inc. - IR Director*

Thank you, operator. Hello, everyone, and thank you for joining us today. The company's results and the Investor Relations presentation were released earlier today and are available on the company's IR website at ir.zto.com.

On the call today from ZTO are Mr. Meisong Lai, Chairman and Chief Executive Officer; and Ms. Huiping Yan, Chief Financial Officer. Mr. Lai will give a brief overview of the company's business operations and highlights followed by Ms. Yan who will go through the financials and guidance. They will both be available to answer your questions during the Q&A session that follows.

I'll remind you that this call may contain forward-looking statements made under the safe harbor provisions of the Private Securities and Litigation Reform Act of 1995. Such statements are based on management's current expectations and current market and operating conditions and relate to events that involve known or unknown risks, uncertainties and other factors, all of which are difficult to predict and many of which are beyond the company's control, which may cause the company's actual results, performance or achievements to differ materially from those in the forward-looking statements. Further information regarding this and other risks, uncertainties and factors is included in the company's filings with the U.S. Securities and Exchange Commission. The company does not undertake any obligation to update any forward-looking statement as a result of new information, future events or otherwise, except as required under law.

It is now my pleasure to introduce Mr. Meisong Lai. Mr. Lai will read through his prepared remarks in their entirety in Chinese before I translate for him in English. Mr. Lai, please go ahead. (foreign language)

Meisong Lai - *ZTO Express (Cayman) Inc. - Founder, Chairman & CEO*

(foreign language)



Sophie Li - ZTO Express (Cayman) Inc. - IR Director

Thank you, Meisong. Now please let me translate first.

Hello, everyone, and thank you for joining our call today. In the first quarter of 2019, ZTO's parcel volume was 2.26 billion, and we generated RMB 970 million adjusted net income. Parcel volume grew 41.6%, which was 19 percentage points faster than the industry average growth. We maintained our leadership position in China's express delivery industry with 18.6% market share at the end of the quarter, which increased 2.5 percentage points over the same period of last year.

During the first quarter, China's express delivery industry maintained a steady growth. We initiated a network-wide volume-incentivizing metric, which was straightforward and fair, aiming to better equip our first-mile outlets to win volume and promote tighter connections as well as alignment of interest in our ZTO outlets and our couriers. The result is improved wages by couriers in terms of higher volume increase. Meanwhile, we continue to reduce the per unit line-haul transportation and sorting hub costs through effective cost control and economy of scale leverage, which helps partially offset the impact of subsidies necessary to [fend off limitation] and achieve steady growth in operating profit in the first quarter.

ZTO has always focused on being the best we can with clear objectives and discipline. The strategic goals and execution plan we developed at the beginning of the year were well implemented in the first quarter. As we grow volume rapidly, we're paying more attention to quality of services. During the first quarter, ZTO's overall customer satisfaction was once again ranked first among Tongda players. More and more customers are recognizing ZTO's brand value, and they're selecting services by ZTO.

In developing our last-mile capabilities, we actively collaborated with Cainiao to rapidly build out the network of express [line-hauls]. The establishment of standardized pickup and the delivery fee schedule across our vast network continues to be underway. This effort includes enforcing differentiated pay schemes for pickup versus delivery. It allows couriers to increase total wages, to improve the ratio between pickup volume and delivery volumes for the outlets and consequently raise the overall level of income and profitability by our network partners.

We continue to invest and build infrastructure, not only to meet the increasing demand from volume increases but also provided for continuous realization of operating efficiencies. Adoption of technology, including data-driven operations, innovation and application of smart technology, has gradually become one of our core competitive advantages. In addition, ZTO is also committed to protect the environment and the poverty alleviation. For instance, the adoption rate of e-waybill has reached more than 99%, particularly reducing paper consumption and waste. Reusable canvas bags that can last more than 100x usages are being widely deployed in our key sorting hubs. Utilization of engine plus trailer combination and the increased utilization of high-capacity trailer trucks not only improves operational efficiency but it's also more environmentally friendly.

Through e-commerce plus express delivery project, we source and distribute agricultural products freshly picked from the fields to all parts of the country quickly at low cost. We have seen valuable experience in supply chain management by bringing our agricultural goods from farmland directly onto dining tables while contributing to poverty eradication. ZTO must not only beat the industry in business operation, but also strive to become corporate citizens who can actively assume a social responsibility.

The outstanding performance in the first quarter came from the concerted efforts of ZTO and our partners from the network. Everyone took a long-term view of the growth prospects of China's express delivery industry and maintain high competence in the healthy and sustainable growth and developments of ZTO. Meanwhile, we focus on tasks on hand one step at a time through fair policies, streamlined management, standardized pickup and delivery fees, data and technology-enabled transit operations. We are one step closer to advancing towards our goal of becoming a scaled platform with superior efficiency, supporting nationwide outlets that are grassroots yet highly profitable.

Now I will pass the call to CFO, Ms. Yan, to go over the financial details.



Huiping Yan - ZTO Express (Cayman) Inc. - CFO

Thank you, Sophie. Good morning, everyone. Thank you for joining our call. As a reference to the section of this call, please refer to the financial details that we posted on our IR website in addition to our standard IR presentation.

First section, financial performance, we will go over financial performance in total before diving into more detail on unit economics. First, to reiterate, average industry growth was 22.5% in first quarter. ZTO was 41.6%, exceeding market average by 19.1 percentage points. We gained market share compared to last year by 2.5 percentage points to reach 18.6%.

With this backdrop, let's now go into line items. First, revenues. Revenues, excluding our COE business, was CNY 4.28 billion, an increase of 31.8%. KA revenues was CNY 544 million, an increase of 66.1%, mainly driven by a 99% parcel volume growth.

Next, cost of goods of operations. All key cost of revenue grew at a rate slower than the volume growth, which demonstrated scale leverage and efficiency gain. First, line-haul transportation cost was CNY 1.59 billion, an increase of 34.7%. Cost of sales on trucks as a percentage of total transportation costs increased from 53.4% to 59.8% year-over-year as the usage of self-owned and more efficient high-capacity trailer trucks increased. The number of self-owned trucks and high-capacity trailer trucks increased to 4,850 and 3,000, respectively, by the end of first quarter 2019.

Two, sorting hub operating costs was CNY 891 million, an increase of 29.8%, which was less than the 41% increase in the volume, demonstrating again effective cost productivity gain.

Next, gross profit. Gross profit margin, excluding our COE business, was 29.3% compared to 31.5% as of first quarter last year. The decrease in gross profit margin was a net result of parcel volume growth and continued cost productivity gain offset by competition-led unit price decline, yet the decline was within our expectation.

SG&A. SG&A, excluding share-based compensation cost as a percentage of revenue, was 6.0% compared to that of 6.1% last year same period. Corporate cost structure remained stable and with leverage. Onetime SBC charge in the first quarter, SBC from Q2 to Q4, will be CNY 10 million, respectively. So in other words, the onetime charge reflects full year's performance bonuses that is charged to the first quarter.

Other operating income, net. This line item includes government subsidies for 2019. The total amount included was CNY 71.9 million -- I'm sorry, was CNY 48.9 million compared to CNY 71.9 million in the first quarter of 2018.

Income from operations. Income from operations, excluding share-based compensation and government subsidies, increased by 20.5%.

Interest income. Interest income increased significantly due to the principal cash balance on deposits increased not only by our operational cash inflow as well as the fact that we received CNY 1.38 billion proceeds from strategic investments led by Alibaba in the second quarter of 2018.

Next, let's talk a little bit about our effective tax rate. Effective tax rate for this quarter was 21.8%, excluding the impact from the nontax-deductible share-based compensation expenses as well as the onshore U.S. dollar deposits, which enjoys a 10% reduced tax rate. With these 2 items taken out, the effective tax rate remained around 17% and 18%. So for the full year, we expect to achieve an effective tax rate of around 18%, 17%.

Net income on a GAAP basis was 900 -- was CNY 682 million. Adjusted net income, which is taking out share-based compensation expenses, was CNY 966 million. Adjusted net income gain, 27.6% compared to last year. Adjusted net income margin was 21.1% compared to 21.4% as of first quarter of 2018. This shows that the adjusted net income margin remains stable.

EBITDA was CNY 1,156 million in this quarter. Adjusted EBITDA was CNY 1,441 million, which increased CNY 342 million. Basic and diluted earnings per ADS was CNY 0.87, which increased 11.5%.



Now let's go into more detail on our unit economics on Page 2. ASP, excluding COE business, declined 7%. It's driven by average weight increase of 2% plus. Incremental subsidies also increased in this quarter, which impacted the ASP by CNY 0.16 downward. Please note that the e-waybill usage has already reached 99.8%. The mix shift that we experienced previously is diminished.

Next, cost of revenue. Excluding COE business, transportation cost as well as sorting hub cost both declined by CNY 0.04 per parcel. For transportation costs, there were 3 main drivers. First, the increase in the percentage of parcel volume delivered by self-owned trucks increased to 68% from 56%. Two, the increase in the percentage of high-capacity trucks went from 54% to 62% in the current quarter. Three, the increase in loading rate has reached above 90%.

Sorting hub costs, there are also 3 main drivers. The average number of self-owned sorting hub workers increased by nearly 16.7%, well below the volume growth of 41.6%. Two, we put through stringent controls on how we use temporary workers so that the mix of temporary workers and permanent hire were healthier this quarter. Three, automation continued to release its efficiency gain. At the end of first quarter, there were 130 sets of automated sorting machines, 99 were for small parcels and 31 for bulk parcels, including integrated dynamic weighing machines. This 130 compared to 59 sets in the first quarter of 2018. As a result, percentage of parcels processed by automation sorting equipment increased to 63% from 53% a year ago.

As a net result of the CNY 0.14 decrease in ASP and net of total CNY 0.05 decrease in the cost per parcel, we have a decline in the gross margin profit by CNY 0.09 per parcel. SG&A, as we talked about earlier, demonstrated healthy corporate leverage, add to gross margin per parcel by CNY 0.02.

Government subsidies declined in the current quarter. The impact was around \$0.01. So our adjusted operating income per parcel declined by \$0.10 to the total of what we talked about above.

Now let's go to the next section, cash and CapEx. Operating cash flow -- inflow increased strong this quarter by CNY 419 million. This is mainly due to strong volume growth, stable cost structure and efficiency gain plus we benefited from interest income as well.

CapEx, let's do a little bit of breakdown. CapEx for the quarter was CNY 922 million, which mainly included land purchases and sorting hub construction costs of about CNY 670 million; purchase of self-owned trucks, CNY 100 million; automated equipment, CNY 130 million. Our annual CapEx plan remains at RMB 6 billion to RMB 8 billion. Cash and cash equivalents reached CNY 17,380 million. Strong cash generation and proceeds of CNY 1.38 billion from investment led by Alibaba in the second quarter were the main driver.

Next, we wanted to confirm that the company is maintaining its full year guidance for 2019.

This concluded our prepared remarks. And as you'll noticed, we have changed our format of our financial detail so that we could allow more time for Q&A. So operator, please open the call for our Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) The first question today comes from Baoying Zhai with Citi.

Baoying Zhai - Citigroup Inc, Research Division - VP & Head of the Hong Kong and China Transport

(foreign language) So first is on ASP. Actually, ASP is better than expected, and I can see from the financial details, we see the weight increased by CNY 0.02, and incentive did increase -- actually was increased CNY 0.16. So how is outlook for these 2 parts going into the rest of 2019?



And we also noticed there's a deliberately decreased policy. This is the second time in this year for ZTO. But ZTO is always going to focus on the balance between the collection and delivery partners. This would hurt the delivery, our [express] outlets a little bit, so how do you bring back balance and how this cause you to be more effective in market share grabbing?

Second question is on cost. Actually, first quarter cost reduction is back on track, and it's much better than expected. Especially on the transportation costs, the loading rate already reached to 90%. How did we achieve that? And are you going to raise up the cost reduction guidance because you only guided 5% unit cost reduction at the beginning of the year, but the first quarter was a good start and it may be better than this? And third question on SBC. SBC was huge in first quarter of this year. What's the reason behind? And how should we forecast going forward?

Meisong Lai - *ZTO Express (Cayman) Inc. - Founder, Chairman & CEO*

(foreign language)

Huiping Yan - *ZTO Express (Cayman) Inc. - CFO*

First, let me translate Chairman's answer first. He commented the fact that total ASP did decline, and it is driven by the incremental incentives. And in a competition environment, we find that it is still effective to use the ASP, the pricing subsidies. And in this quarter, we did increase relatively compared to the previous because of the heating competition.

And to your question, Baoying, that you've asked about the weight, the weight, yes, increased by CNY 0.02 to our ASP. We have done some analysis. We found that without any proactive policy in place, we're actually noticing the packaging of packages became more standardized, and the packaging are heavier. It is actually good in one way because standardized packaging allow us to process automation more effectively. Odd-shaped packages actually could not get processed well on automated machines. As a trend, we believe the weight increases would not be significant because if the driver is simply the packaging. Certainly, as a percentage of the packaging became more standardized, the weight will go up a little bit. But as of current, in the near term, we don't expect the impact to be significant.

Number two, the policy change in -- during May time frame. We plan to -- this is really -- our intention is to better balance the profitability across the entire network by adjusting our last-mile delivery fees, and it actually empowers our network operators to be more incentivized to gain market share locally. The result is that our front-line couriers actually are able to make more money in a sense that the volume has increased, the overall pickup are not just for passive e-commerce packages but more so for the -- including non-e-commerce packages. And despite the adjustment, there was no decline in the last-mile fees. Our last-mile delivery fees are still the highest among the Tongda players.

So now let me answer the next 2 questions regarding cost reduction guidance. Yes, we have improved our cost structure as well as ensured continued investment in high-capacity, high-efficiency transportation vehicles. Our expected productivity gain are -- as we have previously communicated on a one-on-one basis that the low-hanging fruits are going to come from the things that are not necessarily involving technology. The second part of the year, we expect to [have] perhaps more productivity gain coming from introduction of digitized operational tools. So for the full year, we still expect to achieve between 5% to 9%, perhaps as high as 10%, productivity gain.

The fourth question relates to SBC. At the time of grant of our share by the Board, the share price has went up 30% year-over-year. So the SBC price cost is determined by the price and then the next element, by number of shares. Number of shares granted also increased about 10% year-over-year. So the combined impact was 40%. Now in the future, depending on share price and the number of the shares, which we expect likely to increase as well but slightly, maintain steady, we do expect SBC charges to remain reasonable. I hope that answers all your questions, Baoying.

Baoying Zhai - *Citigroup Inc, Research Division - VP & Head of the Hong Kong and China Transport*

(foreign language)



Meisong Lai - ZTO Express (Cayman) Inc. - Founder, Chairman & CEO

(foreign language)

Huiping Yan - ZTO Express (Cayman) Inc. - CFO

So the question was what is the thinking around the incentive subsidies to volume increase. And then Chairman answer that, one, the main consideration surrounding the volume incentive matrix is the volume. If volume continues to increase because of the structure of our incentive matrix, the over -- the total amount of incentives will increase because our goal is to maintain existing volume and stimulate incrementals. And if the volume continues to increase, which means the incrementals are increased, and so therefore our subsidies will increase as a total amount. However, we should also consider the fact that volume brings in not only market share but also profitability. ZTO is very consistent in bringing in effective and profitable volume. So you should expect cost increase, yes, but also our overall margin and profitability continue to expand.

Operator

Your next question comes from Ronald Keung with Goldman Sachs.

Ronald Keung - Goldman Sachs Group Inc., Research Division - Executive Director

(foreign language) I have 2 questions. Firstly, I want to hear about management's priority in achieving volume growth, the volume guidance or the profit guidance. Based on the first quarter trends, you have delivered on both and actually had overdelivered on profit based on the year-on-year trend, which is higher than the full year guidance. Given that buffer, how are we planning to strategize ourselves for the rest of the second, third and fourth quarter? And can you share some trends in the first, April and May, whether the landscape has gone more competitive versus the first quarter? And my second question is about last-mile fees. Yan just mentioned we have one of the highest last-mile fees in the industry. So I would like to hear, are we around 1.6, 1.7 per delivery? Or is there any numbers that you could share?

Huiping Yan - ZTO Express (Cayman) Inc. - CFO

Thank you for your question. I will just take the questions. In our first quarter, we have communicated the fact that sustaining market share is important because there is -- a factor impacting our financial performance is volume. So volume -- if you were to ask us to pick a priority, volume is our first priority. However, again, let's reiterate the fact that we do not bring in noneffective volumes that are not going to generate profit overall for the network. And looking at the second quarter, we do see that the competition remains and the fourth -- the April numbers is out, the average industry growth is still stable and healthy. So we will maintain our strategy in focusing on prioritizing the volume balance with approach to gain further profit growth as well as maintaining high quality of services.

The second question relates to the last mile. The last-mile fee, you've asked what the average rate for the total Tongda, we are CNY 0.15 to CNY 0.20 on average higher, and this quarter is about the same.

Operator

Your next question comes from Edward Xu with Morgan Stanley.

Edward H. Xu - Morgan Stanley, Research Division - Executive Director

(foreign language) Let me just translate my questions. So first, I would like to get any updates on the numbers, for example, the ratio of the breakdown for the revenue from Alibaba, Pinduoduo, JD, et cetera. And the second is could you just share with us how much of the volume handled by the automation and also what's the percentage of the volume for the directly operated trucking routes.



And the second question is regarding the tax because we learned that the government has reduced VAT tax for the logistics industry. So can you quantify the impact, especially any impact for the first quarter? And final question is regarding your volume because we understand that in previous years, first quarter, usually the volume growth on a year-over-year basis was very high. And this year, it's 41.6%, which is very high as well. So could you give us more guidance on the full year target?

Meisong Lai - ZTO Express (Cayman) Inc. - Founder, Chairman & CEO

(foreign language)

Huiping Yan - ZTO Express (Cayman) Inc. - CFO

Okay, now let me explain in English. The percentage of packages from Ali, Tmall and Taobao as a percentage of ZTO is 67% for this quarter. Pinduoduo is around 18%. The second question relating to the number of automation. As we talked about earlier, there are a total of about 136 of automated sorting equipment in place. They process over 63% of our total packages and increased from 63% from last year. Our Chairman reiterated the fact that we have installed more of the bulky parcel processing equipment this year. It's also integrated with the dynamic weighing machine.

The next question relating to the VAT, Edward, that you raised. The -- first of all, we have been very compliant, relatively more compliant than our network partners. The VAT rate that we do that is applicable to us has not really changed significantly. So the impact of this April's VAT rate reduction has very minimum impact on our business.

Regarding our guidance on the overall volume growth, we have -- I'll come back to the direct route question. The overall growth is still considered at -- expected to be at 35% to 40%. And our goal is to continue to be above at least 15 percentage points of the industry average, and we are confident that we are able to achieve that or surpass that.

So a little bit more elaboration on the direct line. The volume increase is really the main driver, and we -- our network needed to be altering as the volume comes in. What we have seen is that because the volume increases, the total number of routes that are running directly from destination to -- from origination to destination, those have slightly increased. And in the future, as volume continue to increase, we will have more significant number of direct runs. As we talked about earlier, the load rate has already achieved over 90%, which, driven by higher volume increases, we will need to, one, establish more routes; and two, opening up more direct routes. So that, at the end, the number of sorting times will reduce and further improve our delivery efficiency. I hope that answers all your questions, Edward.

Operator

Your next question comes from Melissa Chen with China Renaissance.

Melissa Chen - China Renaissance Securities (Hong Kong) Limited, Research Division - Analyst

I have 2 questions. (foreign language) I will translate for myself. So I have 2 questions. The first question is on the macro impact on the industry. So I noticed the volume growth for April is around 31%, which is accelerating from the Q1. So I'm wondering like can management explain this number, if whether we will achieve like 15% above the industry average. And the second question is on the CapEx. So are you going to spend more money in Q2 and Q3. It seems you only spent about CNY 1 billion in 1Q, and will that provide more cost saving for Q4?

Meisong Lai - ZTO Express (Cayman) Inc. - Founder, Chairman & CEO

(foreign language)

Huiping Yan - ZTO Express (Cayman) Inc. - CFO

So I'll translate. Yes, indeed, for April, average increments for the industry is 31 -- over 31%. And just ZTO's strategy is to outperform by at least 15 percentage points. And our performance, in our current view, is in accordance with that strategy. And we are confident that we will be able to deliver on our strategy. The second question relating to the CapEx, the numbers that we have reported is on a cash basis, first of all. So our overall goal is to still to have a plan of around CNY 6 billion to CNY 8 billion for the full year.

Now if I may add, the acquisition of land, that will continue to provide us cost advantage because the rental cost increases are much faster and more significant. The fact that the resources are becoming more and more scarce, so we will continue to focus on securing land resources, building sorting facilities where it's necessary. And the spending goal is CNY 6 billion to CNY 8 billion as of current. Now because of the scarcity, there might be a shortage of smaller parcels. So we are currently looking at larger parcels, which will cost a significantly higher amount in investment, and then we should see in the second and the third quarter this spending amount increase.

Operator

(Operator Instructions) Your next question comes from Calvin Wong with JPMorgan.

C. Wong - JP Morgan Chase & Co, Research Division - Analyst

(foreign language)

Huiping Yan - ZTO Express (Cayman) Inc. - CFO

Thank you, Calvin, for your question. Yes, we do believe that the competition between Baba and Pinduoduo are intensifying. However, ZTO is an open platform, we treat everybody equally, and our focus is to grow our overall volume. The numbers that we provided earlier, 57% on Alibaba and 18% on Pinduoduo, is the result of our fair and equal policy.

Two, you've asked the proportion of CapEx spending, that hasn't changed as of now. Around 65% to 70% will go towards land acquisition, 15% to 20% towards automation and then the remaining 10% to 15% to trucks and improve our price capacity transportation capabilities.

Operator

Your next question comes from Xin Yang with CICC.

The next question comes from Trey Bong with T.H. Capital.

We will then go to the next question with Xin Yang with CICC.

Xin Yang - China International Capital Corporation Limited, Research Division - Analyst

(foreign language) So I'll do translation for myself. First question is regarding the competition. What is your view about the current competitive landscape compared to 2 years ago especially? And the second question is regarding the timely -- the average time that it takes for the total delivery time, what is the average delivery time for ZTO now? And what is (inaudible)?

Meisong Lai - ZTO Express (Cayman) Inc. - Founder, Chairman & CEO

(foreign language)

Huiping Yan - ZTO Express (Cayman) Inc. - CFO

So let me translate the answer. We -- the Chairman says, this is our view and has been consistently our view for the past couple of years that the Chinese express delivery industry has received great support of the growth of the economy, and we are confident that the growth in the future will be also very promising.

The volume increment every year for the last year and this year would've typically, in the past, taken more than 3 or 4 years to achieve, but we have experienced that within 1 year. And then that is a good indication that the future growth prospect is very good. And so ZTO is focusing on our own capabilities in order to meet that demand. So in the past few years, we've continuously invested in our overall transit and sorting capabilities.

This current quarter policy that we have issued are aiming towards balancing pickup and the delivery capabilities so that we could have our frontline incentives reaching not only delivery but also pickup, so that the pickup and the delivery ratio will gradually move towards a balance particularly in some of those regions that are not with concentrated originating packages.

The overall view is when there is competition, there will be improvement and development in capabilities and efficiencies. So our view is very positive and proactive in front of the competition. The -- from sorting hub to sorting hub, average transit turnaround time is 20 hours, and it's improved by 1 to 2 hours.

Operator

We are showing no further questions at this time. This concludes our question-and-answer session. I would like to turn the conference back over to Sophie for any closing remarks.

Sophie Li - ZTO Express (Cayman) Inc. - IR Director

Okay. Thank you, everyone, for joining us this morning. If you have any questions or comments or would like to visit us in China, please don't hesitate to reach out to us, and this concludes the call. Thank you.

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