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SOGO.N - Q3 2019 Sogou Inc Earnings Call

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## PRESENTATION

### Operator

Ladies and gentlemen, thank you for standing by, and welcome to Sogou's Third 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.

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**Jessie Zheng** - *Sogou Inc. - IR Director*

Hello, everyone, and thank you for joining Sogou's Third Quarter 2019 Earnings Conference Call. On the call are CEO, Xiaochuan Wang; and our CFO, Joe Zhou, who will give an overview of the operations and the financial results.

In line with our practice on the previous earnings conference call, Xiaochuan's prepared remarks will be made in Xiaochuan's 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 herein, the matters discussed in this conference call are forward-looking statements. These statements are based on current plans, estimates and projections and, therefore, you should not place undue reliance on them. Forward-looking statements involve inherent risks and uncertainties. We caution you that a number of important factors will cause actual results to differ materially from those containing 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.

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

Thank you, Jessie, and hello, everyone. Despite continuous headwinds in the macro environment and the online advertising industry, we experienced healthy growth in the third quarter with steady top line increase and significant improvement on profitability. This was primarily driven by our constant effort to drive organic traffic growth and unlock the monetization potential of our existing assets.

In the quarter, our total revenue increased 17% year-over-year or over 2 points to RMB 1 billion. Excluding the impact of the onetime [incident] incident in the third quarter of 2018 when we suspended 10 days of online advertising business, on an apples-to-apples basis, total revenue increased 12% year-over-year in RMB.

In regards to our bottom line, as we well managed traffic acquisition cost and continued to improve operational efficiencies in the quarter. Our non-GAAP net income increased 47% year-over-year to RMB 283 million.

In search, Sogou maintained its position as China's second-largest search engine and our search revenue continued to grow faster than the industry average. In Mobile Keyboard, we recorded 464 million DAUs in the quarter, up 14% year-over-year, bringing forth this position as the third-largest Chinese mobile app in terms of DAUs, according to iResearch.

With respect to our Recommendation Service that leverages our Mobile Keyboard, we are glad that revenue ramped up quickly in the quarter, and it is on track to become our second growth engine, following search. In addition, our Smart Hardware business returned to its growth trajectory in the quarter, thanks to the launch of our new AI-enabled products.

Now let's move on to view each of our core businesses, including search, Mobile Keyboard and Smart Hardware. In search, health care vertical and intelligent Q&A remain our priorities as we are committed to building the high-quality search platform.

During the third quarter, we focused on enriching authoritative content, to better address the most frequently searched health care queries, while expanding the coverage of health care encyclopedia content. These efforts resulted in better operational metrics across the board, including a solid increase in the click-through rate of health care search results. We've also continued to stay ahead of peers in both the fulfillment and accuracy rates of our top direct-answer results.

Meanwhile, our ever-improving content ecosystem effectively boosted organic traffic growth in the quarter. As a proof, average daily exposure of the content page on social hubs are climbing as the business platform increased significantly from the prior quarter.

Turning to Mobile Keyboard. Thanks to a number of industry-leading product innovation, Sogou Mobile Keyboard further expanded its user base in the quarter. By the end of September, average daily voice requests made via Sogou Mobile Keyboard increased by 67% year-over-year, which is up to 830 million requests per day, maintaining its position as the largest voice app in China. Moreover, during the quarter, we launched an AI assistant, named [Smart Wanzai] within Mobile Keyboard, which recommends to users an array of emoticons and expressions in chat. This innovative function helps evolve our Mobile Keyboard from a utility software to an AI-enabled communication assistant. Now recommended emoticons and expressions are used hundreds of million times per day on average, and the daily usage number is climbing quickly. In the next step, we will leverage Smart Wanzai to provide more targeted recommendations to address a variety of browsing uncertainties emerging in chat. Driven by these initiatives, in the third quarter, revenue generated from our Recommendation Service that leverages Mobile Keyboard booked a year-over-year increase of over 70%.

At Smart Hardware, as AI hardware, a new [kind] product hit the market, revenue generated from the Smart Hardware business was back onto a growth trajectory during the quarter. In particular, sales volume of AI-enabled smart recorders has got the best selling rate on several mainstream e-commerce platform and gained broad attention throughout the industry.

During the quarter, we have also partnered with leading recorder manufacturers, such as Sony, AIGO, Newmine, to jointly establish an AI Innovation Alliance in which we open Sogou's subscription service to the partners. The Alliance allows us to capture an increasing number of potential users who have the need to translate conversations. It also provides us an opportunity to test the waters for our service-based business model in the

recorder market. In addition, we have devoted R&D effort to high-end AI-enabled recording products for more sophisticated use cases, which will further expand our AI product line.

Moving on to AI. In the third quarter, we consolidated our language-centered AI technology to further support innovation in the search, Mobile Keyboard and Smart Hardware businesses.

In terms of technology, we continued to upgrade our voice and Vocational Avatar technology. In particular, our general capability in voice recognition was significantly upgraded to enable a more natural way of speaking. As a result, our Chinese and English recognition capability in both systems and [new to use] were significantly improved by over 20% in the third quarter. We further reinforced Sogou's differentiation advantage and leading position in the sector.

In terms of application, let me share a few examples. First, by leveraging our voice technology, particularly the new generation of voice recognition model, Sogou Mobile Keyboard improved the accuracy rate of mixed Chinese and English recognition by over 55%. We largely solved the technical issues that have been plaguing the industry for a long time.

Second, our pioneering personalized voice recognition technology-enabled Mobile Keyboard to create a unique recognition model for each user, reducing error rate by over 40% in the words and phrases frequently used by individuals.

Third, Sogou Vocational Avatar has developed into its fourth generation and achieved a major upgrade to empower the virtual avatar with realistic real-time human interaction. During the quarter, we further expanded its use bases into different sectors. We launched the world's first interactive AI customer service within our corporate and online financing platform of Ping An Insurance.

Also, I'd like to give some updates on our partnership with WeChat. In October, we renewed our cooperation with WeChat. In the coming year, Sogou Search will continue to be the preferred engine of WeChat for third-party search services to access external Internet content. Moreover, both WeChat and Sogou intend to extend this partnership year to year until 2023 as part of the overall landmark agreement that Sogou and Tencent entered in September 2018.

Finally, let me share a few thoughts on the rest of 2019. We expect the headwinds in the macro environment in the online advertising industry to continue as well as the ongoing tightened regulations in the Internet sector. While we anticipate short-term softness as the external challenges will impact our Q4 results and then linger into 2020, we have a solid strategy in place.

In search, we will focus on building up our high-quality search platform and driving organic asset growth. At the same time, we are committed to delivering positive momentum in our new growth drivers to accelerate the overall business expansion. We will gear up efforts to push forward the progress the Recommendation Service leveraging Mobile Keyboard and accelerate Smart Hardware growth. We believe we are able to navigate the environment and continue to generate healthy growth and outperform the industry.

With that, I will now turn the call to Joe to go through our financials.

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#### **Yi Zhou** - Sogou Inc. - CFO

Thank you, Xiaochuan. Hello, everyone. In third quarter, our total revenues reached \$315 million. As Xiaochuan mentioned, on an apples-to-apples basis, our total revenues increased 12% year-over-year in RMB terms. The increase was driven by the faster than the industry average growth of search revenue, the strong momentum of Recommendation Service as well as the back-on-track Smart Hardware revenue.

Bottom line-wise, non-GAAP net income grew by 46% year-over-year to \$41 million. Margins improved across the board as we generated increasing contribution from organic traffic, which helped us well contain the traffic acquisition costs. And at the same time, we prudently managed the expenses and improved operational efficiency.



Now I'll walk you through our third quarter 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 excludes share-based compensation expenses. You can find the reconciliation of non-GAAP to GAAP measures in our earnings release.

Total revenues in the third quarter was \$315 million, a 14% increase year-over-year. Search and search-related revenues was \$288 million, a 13% increase year-over-year. The increase was primarily due to growth in auction-based pay-for-click services. Auction-based pay-for-click services accounted for 89% 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 92,000, up 13% year-over-year. The average revenue per advertiser for auction-based pay-for-click services was \$2,800, up 7% year-over-year.

Other revenues were \$27 million, a 25% increase year-over-year. The increase was primarily due to increased revenues from sales of Smart Hardware. With the new models launched and more in the pipeline, we expect hardware sales to keep the momentum for the rest of 2019. Cost of revenues was \$189 million, a 9% increase year-over-year. Traffic acquisition costs, a primary driver of cost of revenues, was \$144 million, a 6% increase year-over-year, representing 46% of total revenues, compared to 49% in the corresponding period in 2018. As we continue to benefit from the increasing contribution from organic traffic, we expect TAC growth to be well contained for the rest of 2019.

Both GAAP and the non-GAAP gross profit were \$126 million, a 22% increase compared to the corresponding period in 2018. Both GAAP and the non-GAAP gross margin increased to 40%, compared to 37% a year ago. The increase primarily resulted from our efforts to control traffic acquisition costs.

Total operating expenses were \$98 million, a 10% decrease year-over-year. Research and development expenses were \$50 million, relatively stable year-over-year, representing 16% of total revenues, compared to 18% in the corresponding period in 2018. Sales and marketing expenses were \$38 million, a 14% decrease year-over-year, representing 12% of total revenues, compared to 16% in the corresponding period in 2018. The decrease was primarily attributable to a decrease in marketing and promotional spending.

G&A expenses were \$11 million, a 31% decrease year-over-year, representing 3% of total revenues, compared to 6% in the corresponding period in 2018. The decrease was primarily due to a decrease in expenses related to noncore business.

Operating income was \$27 million compared to an operating loss of \$7 million in the corresponding period in 2018. Non-GAAP operating income was \$32 million, compared to non-GAAP operating loss of \$3 million in the corresponding period in 2018. Other income net was \$8 million compared to \$24 million in the corresponding period in 2018. The decrease was primarily due to an \$18 million gain from one of Sogou's equity investments recognized in the corresponding period in 2018. Income tax expense was \$2 million, compared to income tax benefit of \$0.4 million in the corresponding period in 2018. Net income attributable to Sogou was \$37 million, a 53% increase year-over-year, compared to net income of \$24 million in the corresponding period in 2018. Non-GAAP net income attributable to Sogou was \$41 million, a 46% increase year-over-year, compared to net income of \$28 million in the corresponding period in 2018.

Basic and diluted earnings per ADS were \$0.09. Non-GAAP basic and diluted earnings per ADS were \$0.10. As of September 30, 2019, we have cash and cash equivalent and short-term investments of \$1.1 billion, compared with \$1 billion as of December 31, 2018. Net operating cash inflow for the third quarter was \$20 million. Capital expenditures for the third quarter was \$0.7 million.

And lastly, turning to our outlook. For the first quarter, we expect total revenues to be in the range of \$290 million to \$310 million, representing 3% decrease to 4% increase year-over-year or a 0% to 7% increase year-over-year in RMB terms. The guidance takes into account the potential impact of the challenges in macroeconomy and the online advertising industry as well as the ongoing tightening regulatory environment in the Internet sector. Please note that for the first quarter 2019 guidance, we have assumed an exchange rate of RMB 7.1 to the dollar as compared with the actual exchange rate of approximately RMB 6.91 to the dollar for the first quarter of 2018 and RMB 6.99 to the dollar for the third quarter of 2019.

That concludes our prepared remarks.

**Jessie Zheng** - Sogou Inc. - IR Director

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

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## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions) And the first question comes from Thomas Chong with Jefferies.

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**Thomas Chong** - Jefferies LLC, Research Division - Equity Analyst

I have a question about the macro headwinds and competition. Can management comment about which sectors are affected more by macro headwinds and which industries are affected more by competition on the short video side? And how should we think about the online advertising market in 2020?

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

(foreign language)

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**Jessie Zheng** - Sogou Inc. - IR Director

[Interpreted] Okay. I just sum up. There are some changes we see in Q4 so far. First, there are some recent regulations start to impact online ad market. For example, the ongoing tightening regulation within tech sector, more or less, impacted sector's ad spend.

In terms of competition in the online ad market, we're seeing increasing competition for ad dollars. For example, advertisers in the gaming and e-commerce sectors tend to allocate more budget to the short video platform.

In terms of the macro environment, we think it's relatively stable as the online advertising market tends to slow down a bit, but it's not something that is materially adverse. So to navigate this set of challenging environment, we have a solid strategy in place. In general, we will focus on new growth drivers, including the Recommendation Service leveraging the Mobile Keyboard to attract new advertising budget stream from clients by offering them a diversified set of ad format. And in search, we will focus on increasing the mindshare of focused search among users by leveraging our Q&A capabilities to provide knowledge-based search results. With that, we will weather this adverse conditions very well.

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### Operator

And the next question comes from Miranda Zhuang with Bank of America.

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**Xiaomeng Zhuang** - BofA Merrill Lynch, Research Division - Associate

(foreign language) So just can management share with us more color about the progress of the Recommendation Services? So any useful metrics on 3 areas, for example, user metrics, operational metrics and revenue metrics?

And also, we noticed that the company recently launched, like, for example, AI assistant and Mini Program platform in Sogou keyboard. So would like you give us -- management to share with us your thinking about this area? And any user feedback on these new services?

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And lastly, I just would like to know the company's expectation or target for the Recommendation Service in next year and in the mid- to long term.

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

(foreign language)

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**Jessie Zheng** - *Sogou Inc. - IR Director*

[Interpreted] Okay. Let me first translate the first part. The Recommendation Service you mentioned, actually Mobile Keyboard is becoming an important driver for Recommendation Services. Essentially, we're trying to evolve Mobile Keyboard from a utility product to a service platform. Mobile Keyboard has 460 million DAUs, an increase of 14% year-over-year with approximately 60% market share, and we expect user-base to further growth.

On the product front, in Q3 there is some changes that we would like to highlight. As we mentioned, we launched innovative feature called [Smart Wanzai]. It basically changes the user interaction format. It's an AI assistant that recommends emoticons and expressions in user chats. Smart Wanzai is intended to strengthen our new brand positioning.

We also are testing the water for VPA-based service in Mobile Keyboard. For now, we are just recommending emoticons and expressions. But as a next step, we're trying to enhance its monetization capability. As Sogou has long excelled in language professing understanding and is often perceived as a language expert, we will enrich and improve the AI service leveraging Smart Wanzai going forward. Meanwhile we'll also drive other innovative functions in Mobile Keyboard, such as Smart Recommendation, to enhance AI capabilities and create AI differentiation.

We've seen very positive feedback from users for Smart Wanzai . We noticed that the recommended emoticon and expressions are used hundreds of millions of accounts per day on average and the daily usage members is climbing very quickly. In terms of revenue contribution, for now, it accounts for roughly 5% of our total revenues. Going forward, we expect it to reach a more meaningful level over time. In the 4Q, the products are both serving user services and also create monetization opportunities.

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**Operator**

And the next question comes from Elsie Cheng with Goldman Sachs.

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

(foreign language) And I'll quickly translate the questions myself. The first question is to Xiaochuan Wang, this year, we have observed Sogou develop -- deployed its AI technology to many vertical solutions as well as the Smart Hardware devices. I would like to ask how would you strategically position for Sogou for the next 2 to 3 years. And can you share with us long-term growth drivers for the company?

My second question is on capital allocation. Your core business margin has been improving on the back of healthy organic traffic growth. And yet, you also have another USD 1 billion cash on the balance sheet. And any plans to deploy that cash into any area of the business?

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

(foreign language)



**Jessie Zheng** - Sogou Inc. - IR Director

[Interpreted] Okay. Let me first sum up our strategic initiatives. Our strategy consists of 3 parts: Search, Mobile Keyboard and Smart Hardware. We will steadily develop search business, and Mobile Keyboard is becoming important driver for Recommendation Service. And we will make a strong effort to accelerate Smart Hardware growth in search or focus building a high-quality search platform. And especially, we would like to leverage our Q&A capability to provide knowledge-based search in addition to information search, to increase the mindshare among users. And in Recommendation -- in Mobile Keyboard, as I mentioned, we're testing the water for VPA-based service to enhance its monetization capability.

And in half year, we have integrated our products into 2 major product lines, Sogou AI and Teemo. We will increase R&D investment in more advanced AI products to capture leading market share. We expect to see a very good growth momentum in 2020. So due to our lot -- the strategic initiatives, we expect that in the future we will ramp up our users revenues as well as our product competitiveness.

Interpreted In addition to integrating AI capabilities to drive the growth of Search and Mobile Keyboard especially, for example, that the health care search and the vertical services and Mobile Keyboard, we are trying to build other forms of monetization streams beyond advertising. So trying to capture allocation. We're leveraging on traffic to deepen our service offerings in addition to search and Mobile Keyboard to generate new growth drivers. So capture will be allocated more to this aspect of new growth initiatives.

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**Operator**

And the next question comes from Alex Yao with JPMorgan.

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**Alex C. Yao** - JP Morgan Chase & Co, Research Division - Head of Asia Internet and New Media Research

(foreign language) So I have 2 questions. Number one is regarding the partnership and the cooperation with WeChat Search. You guys mentioned in the prepared remarks that you just renewed the contract with WeChat such that you will continue to provide general search within WeChat. Would you be able to share with us the latest thoughts on WeChat general search monetization?

And then secondly, can you talk about your competitive positioning in the AI-based Smart Hardware market? We understand there are a lot of competitors with a lot of similar products. What is your competitive advantage? And more importantly, how do we think about the monetization road map for AI-based hardware products in the next couple of years?

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

(foreign language)

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**Jessie Zheng** - Sogou Inc. - IR Director

[Interpreted] Okay. The WeChat agreement is the extension of previous partnership. We are continuing the partnership on the same basis as before. Sogou continue to be the preferred third-party search engine in WeChat to access Internet content. Both WeChat and Sogou intend to extend the agreement year to year until 2023 as part of the overall framework Sogou and Tencent entered in September 2018.

We are in discussions to expand our business collaboration. For example, in the future, we may provide additional search requests, such as image search. And our business collaboration now focuses on the product front. And we had -- it actually increases user activity on WeChat's search platform. The exposure and the click-through rate of Sogou's search result on WeChat continues to increase, and the chats it generated is also on the rise. But as you know, we have been focusing on the product front, and there is no time line for monetization yet.

Interpreted So in terms of Smart Hardware, I think we have very strong core language-centric AI technologies, and we have excelled in our voice computer vision, translation and Q&A technologies and constantly drive product upgrades. We have leveraged our road map of natural interaction



and knowledge computing and apply these core competencies into our AI product to build up our competitive edge, innovation and the enhanced influence of Sogou AI technology.

And one of our key product in 2019 is AI recorder. And because of the success of our AI technology, we have managed to partner with leading recorder manufacturers to jointly establish the AI Innovation Alliance, which allows us to capture potentially new users and also testing the water for service-based business model.

And in terms of our application scenarios, we have excellent use cases for our AI technologies, because we have done search and Mobile Keyboard, one that is information output, the other is information input. And by leveraging our AI capabilities, these can be gradually evolved from assistant, AI assistant-like service to a hardware-oriented service that captures voice, image, that kind of data.

A lot of people believe that speaker is the future of Smart Hardware. But actually, we don't think so. Speaker is only a gateway, but the AI hardware we are looking at is to create more mobility-oriented services. So we believe in the future, under the umbrella of Sogou AI products, we will focus on smart voice interaction products. We want our AI products to gradually evolve into virtual personal assistant.

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**Operator**

(Operator Instructions) And the next question comes from Alicia Yap with Citigroup.

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

I have a follow-up question regarding the macro comment that management made. So I wanted to get a little bit more clarity. Can you elaborate a bit on the challenging macro when you compare in fourth quarter versus 3Q? Do you think that fourth quarter is actually getting worse than what you have seen in the third quarter? And then also on online gaming. Is that mainly your comment which related to the competition from the short video and the gaming does not necessarily seeing the tightening regulation, right?

And then lastly, on the health care vertical, if management can share a bit of color in terms of what is the health care growth, the vertical growth in the third quarter on your search revenue and the revenue contribution from this vertical. And what is your expectation into the fourth quarter?

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**Yi Zhou** - Sogou Inc. - CFO

Okay. So if you're comparing Q4 versus Q3, basically the -- for the micro -- where we do see increasing impact from microeconomy slowdown, as all did. So as Xiaochuan mentioned, such as e-commerce and franchise. So for example, typically, in Q4, it's peak season for e-commerce. But we see a different trend this year in Q4.

And for the increasing competition on ad budget, such as the increasing competition from short video regarding gaming and e-commerce. For health care, it's still one of the top 5 largest sector for our search business.

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

Can I get a bit follow up? So how fast is the health care growth? And have you guys been taking some shares from your major peers?

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

(foreign language)

**Jessie Zheng** - Sogou Inc. - IR Director

[Interpreted] In terms of health care, I just want to add that we are trying to tap opportunities of service-oriented business model in addition to advertising business model. There is an opportunity to connect to a hospital -- hospitals and doctors, so we are going beyond advertising.

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

I see. And actually, can I follow up in terms of the health care? Are we seeing growth and we are taking market share from our peers?

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

(foreign language)

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**Yi Zhou** - Sogou Inc. - CFO

For health care advertising, basically, it's in line with our growth. So we don't see significant market share increase in health care this quarter.

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**Operator**

And the next question comes from Natalie Wu with CICC.

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

I have 2, please. First one is regarding the advertisers. In terms of verticals on year-to-date basis for your top 5 vertical advertisers, which one leads the growth? And which one drags the most of your search business, the 5 largest? And among those verticals which are weaker than you expected, which ones do you think that can be more described as [cyclical] and which one is more related with structural?

And second one is regarding the traffic acquisition costs. Just wondering if there is any different trends in this business in the industry level lately?

(foreign language)

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**Yi Zhou** - Sogou Inc. - CFO

Okay. So first, for our top sectors, they are still e-commerce, health care, gaming, merchant services and the business services. Apart from that, education is among the faster-growing sector in our search advertising. So if you're comparing Q4 versus Q3, there is seasonality because there was summer vacation in Q3. So after that, say, for travel, education, training and gaming, they have a sequential decrease in Q4. So for TAC, first of all, for Q3, because we drive up our organic traffic, so if you look at the TAC as percentage of total revenue, the ratio has been trending down in the first quarter -- first 3 quarters of 2019.

So going forward, it's our strategy to drive up the organic traffic and to improve forward Recommendation Services. So for Recommendation Service for the monetization, it's TAC free. So if you're looking to Q4 2019 and the next year, TAC as percentage to total revenue, they are continuing to trending down.

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**Operator**

Thank you. And at this time, I would like to return the floor to management for any closing comments.

**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**

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

[Portions of this transcript that are marked [Interpreted] were spoken by an interpreter present on the live call.]

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