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ZTO.N - Q4 2019 ZTO Express (Cayman) Inc Earnings Call

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CORPORATE PARTICIPANTS

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

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

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

CONFERENCE CALL PARTICIPANTS

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

Cherry Leung *Sanford C. Bernstein & Co., LLC., Research Division - Research Analyst*

Eric Zong *Macquarie Research - Senior Associates Analyst*

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

PRESENTATION

Operator

Good morning, and welcome to the ZTO Express Fourth Quarter and Fiscal Year 2019 Conference Call. (Operator Instructions) Please note, this conference is being recorded.

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

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

Thank you, operator. Hello, everyone, and sorry for keep you waiting. 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 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 they 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. Lai Song?

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

(foreign language)

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

Thank you, Chairman. Please allow me to translate first. ZTO maintained solid and steady growth momentum in 2019. Our parcel volume was 12.1 billion for the year, increased 42.2% to exceed the average industry growth rate by about 17 percentage points. Our parcel volume market share expanded 2.3 points from last year to reach 19.1%, and we achieved CNY 5.29 billion of adjusted net income, which grew 26%. Our operating cash flow increased 43.1% to reach CNY 6.3 billion. Throughout the year, ZTO consistently increased customer satisfaction, parcel volume and net profit. During 2019, ZTO focused on the primary goal of continued market share gains through accelerated parcel volume. We stepped up on developing our infrastructure, including building our network partners' capabilities, investing in technology and energizing a synergetic ecosystem aiming to improve the competitive strength throughout the full spectrum of ZTO platform. On pickup and delivery, we implemented the standardized pickup and delivery fee schedule to promote sales motivation of the courier personnel. Combined with expanded first and last mile footprint, we were able to reduce cost and improve efficiency.

On sorting hub operation. On top of our existing infrastructure advantage and high installed base of small parcel automation, we increased the number of large parcel processing lines as well as dynamic weighing machines, resulting in further improved productivity.

On long-haul transportation, we further increased the number of high-capacity vehicles and engine-to-trailer ratio. Through various design innovation and better resource planning and consolidation, we aim to maximize the utilization of our transportation capacity.

On quality and customer satisfaction. The end-to-end parcel process is broken down into smaller segments for measure and manage so as to achieve improved timeliness, providing faster and more convenient experience.

On network structure. We tested new design elements, including prestated sorting to improve efficiency in aggregation and dispatching by our outlets. By combining both planning and qualifying more direct routes, we improved connectivity between our origination and destination outlets, reduced the sorting frequency, increased the timeliness, reduced the cost and resources. Delayering of network will prepare us in advance for future volume surge.

On empowering our net partners through our financing arm and its risk management framework, we better utilized our cash reserve to provide relief for operational liquidity as well as CapEx needs for our network partners. This helps to ensure our partners' capability and quality of services are developed to be well in line with our overall growth objectives.

On technology advancement. Data and technology-driven operational systems, including those for faster customer response and last-mile tracking, such as Galaxy, DataEye, Busybees have gradually come online and become increasingly integrated with our vehicles, automation and other equipment as well as operating processes. We have furthered our efforts in digitization and a more effective data-enabled management.

On developing our ecosystem, the LTL business, cross-border international operations, aviation, financing, commerce, warehousing, advertising and last-mile supply chain operations are expanding and growing with concerted efforts. We aim to develop capabilities to provide multifaceted yet customizable services to our customers. At the same time, our ecosystem business also provided cross-pollination for our core express delivery business.

Last, but not the least, as a business that is woven into people's daily lives, we are taking on increasing social responsibilities and are actively engaged in initiative for agriculture revival in certain less-developed regions, alleviating poverty and protecting the environment. Since the start of the coronavirus crisis, we mobilized resource and people within the entire network with synchronized efforts from headquarter to local operations, focusing on both prevention and operations at the same time. We started the normalization process at the end of February, and the entire process was orderly and steadily. Parcel world has since been racing quickly.

Outside of the Hubei province, our operations have since returned to normal, and our market share has returned or exceeded precrisis level. The central government has made extra effort to support the logistics business return to normal operations ahead of other industries. This not only helped to fulfill logistic needs for material and goods critical for coping with the coronavirus, but also to ensure the least amount of interruptions in supplying for everyday needs for the Chinese people.

It is inevitable that the coronavirus caused immediate negative impact on our business operations. However, we believe the long-term growth prospects of the Chinese economy have not materially changed. Domestic consumption needs are still strong. Hence, express delivery industry will continue to benefit from -- with medium to high growth in the near term. We are confident in achieving a volume growth that is at least 16 percentage points above the industry average and expanding our market share by at least another 2 percentage points for year 2020. We believe by relying on our brand and our comprehensive strengths, including resourcing people, infrastructure and the financial, we are able to seize the opportunities to restructure transformation in the Chinese express delivery industry and advance from leadership to superiority.

With that, let's hear from our CFO Huiping Yan on financials and forecast.

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

Thank you, Chairman. Thank you, Sophie, and hello to everyone on the call. As I go through our financial results, please note that unless specifically noted, all numbers quoted are in RMB and percentage changes refers to either 4Q or year-over-year. Detailed analysis of our financial performance, unit economics and cash flow are posted on our website, and I will only highlight some of the key points here in consideration of time.

Our parcel volume grew 16.9 percentage points over and above the industry average in 2019, and our market share rose to 19.1%. If I may point out to you that the incremental 3.6 billion parcels for 2019 represented approximately over 28% of the total Chinese express delivery industry, increase of 12.8 billion from previous 50.7 billion in 2018 to 63.5 billion for 2019. We continue to lead the industry on absolute number of parcel growth.

Gross profit grew 23.4% for Q4 and 28.8% for the year is a net result of: one, strong volume increase; two, competition-led price decline; and three, significant and notable operational cost productivity gain.

On Chairman's notation, we've reported increases of our productivity gain for 2019. Year-over-year comparative combined cost for transportation and sortation cost declined 11% or 9.1% reduction year-over-year. Going forward, more measures will be brought online to leverage the scale and streamline resources as well as application of technologies so as to further drive down operational costs. We expect the combined sortation and transportation cost per parcel for this year 2020 will be around the range of 10%, to say at least.

SG&A costs included share-based compensation expense, which is closely associated with KPI and performances of the business, increased 26.9% for the year. Excluding SBC, SG&A as a percentage of the revenue were 5.6% for both 4Q and the year compared to that of 5.5% in 2018.

Corporate cost structure is stable, and its leverage on scale is very healthy. Income from operations, excluding SBC, grew 33.5% for 4Q and 26.1% for the year, and associated margin rate improved 2.3 percentage points for Q4 and 0.1 point for the year. Excluding SBC and onetime items, adjusted net income grew 26.5% for Q4 and 26% for the year, demonstrating ZTO's ability to focus on our strategy of volume growth and market share gain while maximizing its operating assets, particularly in a highly competitive environment.

Operating cash flow was CNY 2.26 billion for Q4 and CNY 6.3 billion for the year, increasing, respectively, 25.4% and 43.1%. CapEx For the year was CNY 5.23 billion.

As we further strengthen our infrastructure in anticipation of future volume increases for the core business as well as resource planning for development of our ecosystem, our annual CapEx would remain around CNY 6 billion to CNY 8 billion for 2020.

The company announced an extension of the current share buyback program to June 30, 2021, and the company also announced for shareholders on record as of April 8, 2020, a USD 0.30 dividend for the year.

Now let's move on to business outlook. As we mentioned that the immediate impact for coronaviruses on our business is reasonably estimable. Our March performances in both volume and the business operations, which represent the underlying asset utilization, give us strong indication that given the overall condition being stable, we are confident to achieve our goal for volume growth, which is at least 15 percentage points over and above industry average for the year.

Taking into consideration the immediate impact and also the March performance so far, we are optimistic that our ability to continue to execute in the year with our intact operational foundation, we are hopeful, however, because of the dimension and also duration of the crisis, which is currently extending over the rest of the world, allowed us or prevented us from providing specific guidance at this time. So as our visibility improves, we will provide better and more particular assessments of the scenarios going forward for the year.

With that, we conclude our prepared remarks. Operator, please open the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from Baoying Zhai from Citi.

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

(foreign language) So first of all, I wanted to ask a question regarding the competition strategy and the industrial landscape. We are actually seeing currently the very intensive plus world-class epidemic shall provide a good window of opportunity to clear industry landscape sooner than expected. But meanwhile, we see a lot of new entrants into this industry as well, such as [J&T Express], [Shentong Express]. So I wanted to ask lighter view on this year's landscape involvement and how ZTO would react to this?

Secondly is regarding 2020 outlook. I well understand there are a lot of uncertainties caused by the epidemic. But as we look beyond the first quarter, may we get a more specific guidance on the demand and the cost trend in the next few quarters? And on the cost front, could Huiping share more color or light on -- share more color on last-mile solutions build-out plan this year and the target parcel ratio which are going to be put in lockers and posts.

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

(foreign language)

Operator

Your next question comes from Ronald Keung from Goldman Sachs.

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

Let me ask the question in Chinese, and then I'll translate. (foreign language) I have 2 questions. First is about the industry structure following on Baoying's question. Just wanted to hear, do we see any room or potential between the top 5 franchise players for either partnerships or alliance? Or do we see it's more likely that each will still be on a very individual basis and competing on, as you say, scale and efficiency? My second question is on transit times. Could you share just on average parcels in 2019? What was the mix of parcels that are delivered between kind of 2 days, 3 days, 4 days? And are there any targets for 2020?

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

(foreign language)

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

[Interpreted] First of all, let me translate for the Chairman on his answer to Baoying's question. In short, the concentration of the business is trending to be the case and what's determined what will survive and not is really the ability to scale up and also managing costs. And then to answer your question, the Chairman says, the likelihood of these 5 businesses consolidating is low. Now with the development of our ecosystem and particularly so for our core express delivery businesses, we are focusing on delayering of the network as well as strengthening the connection between origination and the destination so as to reduce cost and improve efficiency.

Now please allow me to answer Baoying's question that was addressed to me earlier. Our cost advantage is in our ability to innovate as well as leverage our ability to gain productivity on scale. Going forward, we will continue to gradually introduce and implement effective measures on particularly transportation costs as well as our sorting hub costs. Our historical track record provided us strong confidence that going forward, particularly in 2020, we're able to achieve 8% to 10% of productivity.

Now very quickly on the last-mile development. Our goal is to achieve 70,000 total installed posts by the end of the year. This year, we have joined together with Cainiao Post to develop 5,000. In addition, we have over 25,000 posts that are operating under the ZTO brand. It is critical to have a last mile efficient network because as volume comes through, while the platform is capable of scaling up, the key is to ensure the last mile and also the first mile has the capability to coordinate and put through the volume. So efficiency gain, capacity building is what we are focusing for 2020.

Operator

Your next question comes from [Thomas Chung] from Goldman Sachs.

Unidentified Analyst

This is [Lee] asking on behalf of Thomas. (foreign language) Thanks management for taking our questions. And we appreciate if management could provide some colors on the parcel volume trend in the month of January, February and March and then the parcel volume growth in 2020 and expectations on market share over the next couple of years.

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

(foreign language)

Operator

(Operator Instructions) Your next question comes from Eric Zong from Macquarie.

Eric Zong - *Macquarie Research - Senior Associates Analyst*

(foreign language) I have 2 questions. The first question is regarding key accounts business. So basically, we have seen a slower increase in parcel volume for key accounts in the fourth quarter. However, a gross profit margin is actually quite stable at CNY 0.47 per parcel. So what's your guidance going forward on parcel volume growth and unit economies for KA?

So my second question is for last mile delivery fee. Basically, we have seen (inaudible) cutting last mile delivery fee last year and also first quarter. So what's your view on the guidance on last mile delivery fee cut for the whole year?

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

[Interpreted] Okay. I'll first answer the KA question. In the fourth quarter, KA volume increase was see 7.3% -- KA volume was 7.3% of the total volume, increased 23% compared to last year. Now KA business is largely for customers such as Ctrip and Alipay. And we have seen that these customers' volume has reached a level to where they are not increasing significantly. Now there is another part where we are reducing some of the businesses from large KA accounts that are not returning the fees as quickly as they can. So we are proactively controlling the volume growth. And the third aspect is that some of the businesses are able to be carried out by our outlets. So therefore, we allow them to serve the KA customers.

Now on the second question, the last mile delivery fee, we have various mechanisms in place to balance the entire network in face of competition. It is our philosophy to ensure fairness and open transparency. With the current volume increase, we are potentially adjusting the fee to be down about CNY 0.10. Now with that, again, volume and price determines the total income and profitability of our last mile partners. So therefore, we have closely been watching the balance and the estimate is per ticket CNY 0.10 per year. Overall, the fees are not reducing, it's just being properly reallocated.

If I'm still online, I would like to supplement for the previous question with -- translation for the answer. For the first 3 months of this year, the trend of our parcel volume led us to believe there is a good scenario that our total volume would reach the same as last year or perhaps exceed. The market share goal for us, as Chairman confirmed earlier, we are targeting to grow 15 percentage points over and above the industry average, and we are pretty confident in achieving that.

Operator

(Operator Instructions) Your next question is a follow-up from Baoying Zhai from Citi.

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

(foreign language) Sorry, let me translate my questions first...

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

[Interpreted] Okay. Baoying's question is regarding the cost -- okay, Baoying, I'll just say that in English for you. The question is around cost because starting February 17, the government had issued policy to waive the ETC fees for transportation businesses. And further on that, Baoying is asking what our assessment of the overall cost situation under the coronavirus is.

So my answer to that is, one, we have pretty much no income, but the costs, largely fixed cost portion, are there for the businesses. So the impact on the first 2 months before the business resumed volume, we are sitting on that losses. Now if I were to reference last year first quarter, RMB 966 million is our net income. And if we look at this year, it is a likely scenario. Again, I'm saying it's a likely scenario, it's certainly not a guidance, that we are looking at a CNY 500 million to CNY 600 million impact to our net income. And this is one of the scenarios. March operation has resumed, and we said that the volume has gone back to precrisis level. Based on the current view, our volume for the quarter would reach or potentially exceed last year's volume. So our estimate for the earnings on first quarter, again, is normalized, but taking into consideration the impact for the first 2 months.

The second question relates to VAT. The super deduction is a 2-year program provided by the government on VAT taxes for import tax. The import VAT, once it's reached a certain level, could be taking on an added 10% deduction straight to offset income -- taxable income. And then so we are enjoying this benefit starting in August of last year, and we expect to continue to benefit this through 2021 when the program is scheduled to end.

Operator

Your final question comes from Cherry Leung from Bernstein.

Cherry Leung - *Sanford C. Bernstein & Co., LLC., Research Division - Research Analyst*

(foreign language) So I have a question regarding C2C private parcel amount this year's volume mix. Last year in the Investor Day, the management mentioned about C2C expansion would be one of the key strategies for this year. I would like to ask whether there is a target for C2C to reach a certain percentage of mix in total volume this year and how is the pricing of C2C is going to be targeted versus e-commerce parcels.

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

(foreign language)

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

[Interpreted] Throughout the past, the composition of our parcel volume has been improving in a way that the individual...

(technical difficulty)

Operator

We have temporary loss of contact to the speakers. (Operator Instructions)

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

Can you hear us? Okay. I don't know where I stopped, but I'll repeat, and I apologize for that if you heard it again. The composition of our total packages has been improving and especially as we develop our (inaudible) aviation union businesses as well as collaboration with (inaudible) the individual packages, i.e. non-e-commerce packages proportion has been increasing rather quickly. The individual packages associated costs are just slightly above our core normal packages because of the timeliness requirements. However, the pricing part is meaningfully higher than our core packages. So therefore, the structure and also the profitability is better, and we are continuing striving to improve that mix.

I believe this is our last question, so we are looking forward to discuss with you in more detail offline, and we apologize for the technical difficulties we experienced today. And again, the business is confident in looking forward for a stable recovery of the commerce in China. And also, we have strong belief in Chinese ability to protect its situation in the crisis environment. Based on our own ability and within our own control, we are much advantaged in terms of resources in infrastructure, people, market leadership, cost advantage as well as our financial strength. With that, we thank you for your attention, and we look forward to speaking with you again. Thank you.

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