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Ms. Helen Jing Zhu; Director, IR
Mr. Fu Sheng; CEO, Director
Mr. Andy Yeung; CFO

Analysts
David Sun, Morgan Stanley
Evan Zhou, Credit Suisse
Wendy Huang, Macquarie
Eric Wen, Blue Lotus

Presentation

Operator: Welcome to the Cheetah Mobile second quarter 2016 earnings conference call. All participants will be in listen-only mode. (Operator Instructions). After today's presentation there will an opportunity to ask questions. (Operator Instructions). Please note this conference is being recorded.

I would now like to turn the conference over to Helen Zhu. Please go ahead.

Helen Jing Zhu: Thank you, Operator. Welcome to Cheetah Mobile's second quarter earnings conference call. With us today are our Mr. Fu Sheng, CEO, and Mr. Andy Yeung, CFO.

Following management's prepared remarks, we will conduct a Q&A session.

Before we begin, I refer you to the Safe Harbor statements in our earnings release, which also applies to our conference call today, as we will make forward-looking statements.

At this time, I would now like to turn the conference call over to our CEO, Mr. Fu Sheng. Please go ahead, Fu.

Fu Sheng: Thanks, Helen. Hello, everyone. As we said on our first quarter earnings call, we had a challenging beginning in the second quarter and set out to implement a series of initiatives to restart growth and improve our financial performance and to establish a sustainable and profitable growth model for the long term.
The centerpiece of our plan is the transformation of our Company from a mobile utility app company to a content-driven mobile internet company. Moving speedily and with determination, and much hard work from our staff, I am delighted that these efforts are starting to bear fruit.

Our short-term initiatives, which included refreshing our existing app products and ad layouts as well as improvement in our sales programs, particularly for direct sales, have helped us stop mobile revenue declines that took place in the early part this year. In fact, we delivered better-than-expected total revenue growth in the second quarter.

We now expect revenues to resume quarter-over-quarter growth in the second half this year, driven by steady and sustained revenue growth generated by our existing utility apps and continuing improvement in our sales programs.

But more importantly, we also made solid progress on our content strategy. With the recent product rollouts, our content-driven product portfolio now includes news service, short video, live streaming and casual gaming.

Most notably, two of our content-driven products, News Republic and Live.me, showed strong performance over the past quarter, particularly in the U.S. market.

To accelerate our news app rollout and avoid copyright issues worldwide, we recently acquired News Republic for $57 million. The French and San Francisco-based News Republic is a global mobile news service operator with thousands of high-profile media partners around the world.

Although News Republic is now a wholly owned subsidiary of Cheetah Mobile, the award-winning News Republic app will continue to operate on a standalone basis. In fact, with continued improvement and support from Cheetah since the acquisition, News Republic has been moving up on the app chart and was ranked as one of the top three news and magazine apps in the U.S. on Google Play in July according to App Annie.

Live.me, a live streaming app, which was developed in-house and recently rolled out, was ranked as one of the top 5 social apps in the U.S. on Google Play in July, and has recently been ranked as one of the top 10 social network apps in the U.S. on Apple App Store. So far this quarter, the successful growth of Live.me has continued as we see user numbers growing rapidly.

On the light casual game side, Piano Tiles 2 and Rolling Sky continue to perform well and were both among the top five most downloaded mobile games in the U.S. according to App Annie.

While we are encouraged by the progress of our content strategy so far, I would stress that at our core, Cheetah is a technology product company. We know that our continuing
success, be it in the utility app space or the content-driven app space, lies in our ability to leverage the big data generated by our 600 million-plus active mobile users and our ability to develop the best applications with the best experience for our users.

In the mobile age, content consumption has become more fragmented and the content is increasingly being pushed to rather than pull by mobile users. So for our content strategy, it means delivering more personalized and relevant content to users when and where they want it. Hence, we continue to invest heavily in our data analytics.

On the user side, we are deploying big data analytics to help us better understand and profile the wants and the needs of our users.

On the content side, we are using A.I. and machine learning algorithms to better analyze and profile the millions of videos, music, graphics and texts generated by our users and content partners on a daily basis.

The ongoing success of our news app, InstaNews, in India shows that our algorithms work well in delivering more custom and relevant contents to our users, accurately and efficiently, despite only having limited cultural and language in-house.

Finally, while we don’t want to downplay the challenge we face in our transformation from a utility app-based mobile company to a content-driven mobile company, our initial successes give us the confidence that we are on the right track to improve our growth and profit profile and progress further according to plans.

Looking ahead, we remain focused on aggressively executing on our content strategy to establish a sustainable and profitable growth model for the long term.

With that, I will hand over the call to our CFO, Andy.

Andy Yeung: Thanks, Sheng. Hello, everyone. First of all, I am pleased to announce that we delivered better-than-expected total revenue growth in the second quarter, thanks to our successful strategy to rejuvenate revenue growth in 2016, including refreshing our products and ad layouts, as well as improving direct sales programs.

But given the importance of the transformation that we are undertaking this year, there are a few moving parts in our business model. So to help you better understand the performance of our business operations, I will first give you an overview of our financial performance and some additional colors on our existing businesses, as well as the level of investment and progress that we are making in our new content-driven products.

In the second quarter, total revenues grew by 18% year-over-year to RMB1.05 billion, which exceeded the high end of our revenue guidance by almost 5%.
New content products, including the newly acquired News Republic, accounted for roughly 1% of total revenues in the quarter.

While we incurred a net loss of RMB150 million on a GAAP basis and a net loss of RMB62 million on a non-GAAP basis, the decline in net income was largely attributable to a one-time non-cash investment impairment of RMB95 million; and stepped-up investments in new content-driven products, which amounted to roughly RMB50 million in the quarter.

In fact, we generated roughly RMB130 million operating cash flow and almost RMB90 million in free cash flow in the second quarter. Excluding SBC expenses and the impact of our new content-driven products, our existing products would have generated 17% year-over-year increase in revenues and almost RMB65 million in operating profits.

Looking ahead, for the third quarter, we currently expect and estimate total revenues for the third quarter to be between RMB1.10 billion and RMB1.15 billion, representing a 7% to 12% year-over-year increase and 5% to 10% growth quarter-over-quarter. Please note, this forecast reflects the Company’s current and preliminary view and is subject to change.

The implied quarter-over-quarter growth was primarily driven by a resumed sequential mobile revenue increases, thanks to steady and sustained revenue growth generated by our existing utility apps.

In the second half of 2016, we will continue to implement strict cost controls. In particular, we will be more focused on optimizing our marketing spending, shifting some of our promotional activities on utility apps onto content-related spending and focusing more on specific developed markets.

Our goal is to sustain revenue growth, albeit more moderate growth, and expand profitability of our existing business lines, while stepped-up investment in order to build upon the success and accelerate the growth of our new content-driven products.

In the third quarter, we expect to invest roughly RMB150 million in content, R&D and marketing for our new content-driven products, funded mostly through the profits generated from our existing businesses.

All in all, we expect these initiatives to continue to drive our overall financial recovery starting from the third quarter and lay a solid foundation for another round of strong monetization, revenue growth and profitability improvement in the coming years.

Now, let me walk you through the details of our second quarter performance. All financial numbers are in RMB unless otherwise noted.
In June, Mobile MAUs were 623 million, increased 26% year-over-year and declined 4% quarter-over-quarter. The sequential decline to our mobile MAUs was mainly attributable to, one, the decline in mobile MAUs for Piano Tiles 2 which has entered into the mature stage of its product lifecycle; two, the Company’s strategic decision to focus on developed markets.

The MAUs for the Company's core utility application continues to remain flattish quarter-over-quarter. The Company's mobile MAUs in the developed markets, including North America and Europe, increased modestly quarter-over-quarter.

In the second quarter, total revenues grew by 18% year-over-year to RMB1.05 billion.

By platform, mobile revenues grew by 37% year-over-year to RMB772 million for the second quarter. Mobile revenues accounted for 74% of our total revenues in the quarter, up from 64% in the prior year period.

PC revenues declined by 15% year-over-year in the second quarter. The decreases in PC revenues were mainly due to the migration of internet traffic from PC to mobile in China.

By region, overseas revenues were RMB561 million for the quarter, up 25% year-over-year. Overseas revenues accounted for 54% of total revenues or 73% of mobile revenues in this quarter.

China revenues increased by 11% year-over-year. The China revenue growth was supported by continued revenue increase from our mobile advertising business in the domestic market.

By segment, revenues from online marketing services were RMB939 million for the quarter, up 24% year-over-year. The increases were driven by our mobile user base, and increased demand from advertisers as well as the monetization of our light causal game through in-game advertising.

Revenues from IVAS for the second quarter were approximately RMB80 million, a decrease of 27% year-over-year. The decreases were primarily driven by a decline of our mobile game publishing revenues in China, which offset our growth in overseas markets.

Revenues from internet security services and others for the quarter were approximately RMB28 million, an increase of 42% year-over-year. The increase was primarily due to increased internet software licensing revenues contributed by Kingsoft Japan.

Moving on to our costs and expenses -- SBC expenses for the second quarter were approximately RMB89 million, compared to RMB56 million in same period last year.

To help facilitate the discussions of the Company’s operating performance, the following discussion will be on a non-GAAP basis, which excludes stock-based compensation.
expenses. For financial information presented in accordance with U.S. GAAP, please refer to our press release which is available on our website.

Non-GAAP costs of revenues for the second quarter were RMB355 million, up 59% year-over-year. The increases were primarily due to stepped-up investments in contents for our content-driven products, an increase in traffic acquisition costs associated with our third-party advertising publishing business on the Cheetah Ad Platform, and an increase in bandwidth and internet data center costs associated with increased user traffic and data analytics.

Non-GAAP gross profit for the second quarter was RMB692 million, up 4% year-over-year.

Non-GAAP R&D expenses for the second quarter were RMB178 million, up 38% year-over-year. The increases were primarily due to increased headcount associated with our stepped-up investments in big data analytics and new product development.

At the end of the quarter, we had approximately 1,800 R&D personnel.

Non-GAAP sales and marketing expenses for the second quarter were RMB406 million, up 17% year-over-year. The increase was primarily due to the spending on promotional activities for our content-driven products. This increase was also due to an increase in the number of sales and marketing staff.

Non-GAAP G&A expenses for the second quarter were RMB123 million, up 43% year-over-year. The increases were mainly due to increased headcount associated with being a public company and higher staff benefits.

Other operating income was RMB40 million for the second quarter of 2016. Other operating income primarily consisted of government grants, subsidies and financial incentives.

Non-GAAP operating profit for the second quarter was RMB26 million, a decrease of 71% year-over-year.

The Company recognized impairment losses of long-term investments of RMB95 million for this quarter, primarily driven by one-time non-cash write-downs in certain investment assets.

Non-GAAP net loss for the second quarter was RMB62 million, as compared to a non-GAAP net profit of RMB116 million for the same period last year. The losses were partly attributable to stepped-up investments in content-driven products and a RMB95 million net impairment loss of investments in this quarter.
Non-GAAP diluted loss per ADS for the second quarter was RMB0.44, or $0.07 cents, as compared to non-GAAP diluted earnings per ADS of RMB0.81 for the same period last year.

Adjusted EBITDA for the second quarter was RMB68 million, a decrease of 46% year-over-year.

Lastly, before we start the Q&A session, I would like to remind investors and analysts that in March, 2016, the Board of Directors authorized a one-year share repurchase plan, allowing to the Company to buy back up to $100 million in aggregate value of its ADSs.

As of August 18, 2016, the Company has repurchased a total of 2.54 million ADSs, representing 25.4 million Class A ordinary shares, at an average price of $10.75 per ADS. The share repurchase program reflects our belief that our shares are presently undervalued and demonstrates our confidence in the long-term outlook for our business.

And this concludes our prepared remarks for today. Operator, we are now ready to take questions.

**Question-and-Answer Session**

Operator: We will now begin the question-and-answer session. David Sun, Morgan Stanley.

David Sun: (Spoken in foreign language). So my question is that can management provide some updates on the overall (inaudible) the revenue from Facebook? The new guidance, the sequential improvement, does it imply that the revenue from Facebook is recovering? And also, what's the current eCPM trend of the ads from Facebook? Thanks.

Fu Sheng: Okay. (Spoken in foreign language).

Andy Yeung: (Interpreted). Thank you, David, for the questions. So some people (inaudible) your question, I think in addition to the Facebook between (inaudible) mentioned in the prepared remarks in the quarter to (inaudible) how we're shifting focus from (inaudible) market to (inaudible) market, where the user (inaudible) actually have increased. And also (inaudible) also stronger.

In addition to that, we also (inaudible) single customer relationship or (inaudible) customer, we'll just say that in general, further color, we also have [watched that] closely (inaudible) in addition to Facebook. In addition to that, we also have (inaudible) which also strengthen (inaudible) right now.
So all in all, it's a combination of many factors in the quarter, in the second half of the quarter, that helped us to [restart] the revenue costs (inaudible).

David Sun: (Spoken in foreign language), Andy.

Operator: Evan Zhou, Credit Suisse.

Evan Zhou: (Spoken in foreign language). Please translate the question. The first question is regarding the content product, newly launched content product. Revenue contribution, according to the prepared remarks, was only at 1%. I was wondering how will that trajectory be in the following quarters?

And specifically, on the Live product, Live.me, how further maybe Fu can share with us some insights about the competitive landscape in the U.S. and the developed markets, and also how you think about how this product can evolve to contribute more to our Company. Thank you.

Andy Yeung: Thank you, Evan, for the question. So your first question regarding revenue contribution from our new product, new content product, so our (inaudible) product actually is improving more than Live.me. Live.me is making strong progress in the quarter, but we also have a new service, (inaudible) India [InstaNews]. And also globally, we (inaudible) New Republic and then we also have a couple other new applications in the marketplace.

(Inaudible) roughly what the sale of our (inaudible) news and we [do] not expect content product to really become a significant part of our revenue until 2017 the earliest (inaudible) all new product while we test monetization, but we generally are not (inaudible) at the beginning.

Our goal right now is as we have strong in the second quarter, all our new products and then try to improve those products, and then acquire more users, and then (inaudible) the user traffic and (inaudible) monetization. So for the third quarter and the fourth quarter, we can expect some [small] increase in revenue contribution from the new content products, but they're not going to be material, at least as far as we can see [at this point].

I would like to actually answer your third question regarding his view on the live-stream video operations in the U.S. and other countries.

Fu Sheng: (Spoken in foreign language).

Andy Yeung: (Interpreted). All right. So live-streaming I think is not (inaudible) in China, but we can go back globally, that (inaudible) very exciting if you look at (inaudible) I think their (inaudible) one of the most exciting products (inaudible). So the (inaudible) product, we have launched our product about 2, 3 months ago and as you can see on (inaudible) Google Play and Apple App Store, we are happy (inaudible) by the user and
we came very high in ratings for our products (inaudible) us and have a lot of advantage compared to other products (inaudible).

But as we mentioned during our prepared remarks, you can see that (inaudible) in the U.S. (inaudible) on Google Play in the U.S. And if you look at (inaudible) the top 10 (inaudible) network (inaudible) in the U.S. (Inaudible) our product (inaudible) in the marketplace.

Evan Zhou: (Spoken in foreign language). Let me please translate. So the question is regarding the cost that's involved in [upcoming] quarters regarding pushing out new product. Wondering what kind of (inaudible) behind the mix of the costs? Is it more related to the app installed base (inaudible) that would be acquired from external traffic, or is it more related to some content spending that's related to acquiring quality content in our new products such as News Republic and Live.me? Thank you.

Andy Yeung: Right. So if you look at what we said about investment in the second quarter for the new products, including Live.me, News Republic as far as the (inaudible) other product applications, it would be used (inaudible) among all different areas of content, [acquired] content, invest in R&D not only in cost, but also in (inaudible) other [technology] stuff that we need to develop in order to have a wonderful user experience for our app user.

And also, in the [fall] promotion of the application and promotion does not necessarily mean [installation]. In fact, there's no [installation] in the U.S. So it's not only (inaudible) to online marketing, but also including brands (inaudible) product promotion (inaudible) organized to (inaudible) applications and the branding of those applications. Hopefully, that has answered your question.

Evan Zhou: Yes, thanks, Andy.

Operator: Wendy Huang, Macquarie.

Wendy Huang: This is Wendy Huang from Macquarie. (Spoken in foreign language). So I have three simple questions. The first is actually about the revenue recognition of the News Republic, Rolling Sky, [1002], etc., whether you are actually booking it under the marketing (inaudible) or the value-added subsets.

And the second is how much is your Q2 revenue guidance actually is coming from those three things that I just mentioned? The last thing is about the gross margin trend. It seems that gross margin declined a little bit in the quarter. What's the reason behind it and how should we expect the trend going forward? Thank you.

Andy Yeung: Okay. So, Wendy, thank you for the question. So to answer your questions, in terms of the (inaudible) revenues from the new product, actually for the News
Republic as well as Live.me, mainly in the online marketing [subsets]. For Rolling Sky and also for [1002], those are the two casual games (inaudible) that we have.

Also, mainly in the online marketing [subsets] because we monetize it mainly through advertising, although we do have some revenue contribution from those two games in (inaudible) because there's also some small contribution from users purchasing [in-game] game items.

So the second question regarding our guidance, as you mentioned, for those three quarters, those were our content quarters, and we don’t give guidance for the games themselves. But if you look at Live.me, News Republic, the news (inaudible) as well as all the apps that we have rolled out recently, those products (inaudible) a small portion of our revenues (inaudible) we expect some increase, but not that big an increase at this point.

As we mentioned right now, our main focus for the new content products are on refining those products and finding more users, not monetizing in this economy. So we do expect them to (inaudible) grow.

In terms of the valuations for (inaudible) was approximately [$7 million]. We do not disclose the (inaudible) matrix that we use, but as you mentioned, the revenue contribution from all three (inaudible) products making our new product portfolio right now. This (inaudible) is only one of them and so their revenue contributions are limited. Given the scale of their revenues, they (inaudible) losses while (inaudible) they actually cost [loss-making] and profit-making.

So that will likely be the case for at least two more quarters until we can ramp up more (inaudible) for that product. And again, when the first (inaudible) this is a good property and a strong brand (inaudible) user. Our goal is really to give them support to improve their product and then also (inaudible) improve the execution of the application and the (inaudible).

And the last question I think is about gross margins. The gross margin declines (inaudible) critical to increase in content with cost (inaudible) product grow in terms of users and revenues (inaudible) the improvement of the gross profit margin, but I did [find] the scale, when compared to the revenues. So we do incur a higher content cost as a percentage of revenues right now.

Wendy Huang: So how should we expect the gross margin trend going --

Andy Yeung: I think we do --

Wendy Huang: So do we expect the content costs to continue to trend higher in the future quarter as well?
Andy Yeung: It should not be that much higher. Obviously, (inaudible) product, a lot is cost that we did not incur before show up, but incremental increase should not be that large. I think (inaudible) can look at the low 60s margin, gross margin, as a fairly reasonable way to look at it. But I think at the same time, (inaudible) may have a couple more before they go (inaudible) some of these products (inaudible) content. But I think 60% is probably a reasonable way of looking at it.

Then as those products really [ramp up] to revenues, we should begin to see our gross margin begin to recover, hopefully, the early part of next year.

Wendy Huang: Thank you.

Operator: (Operator Instructions). Eric Wen, Blue Lotus.

Eric Wen: (Spoken in foreign language). I have three questions. My first question is how much percentage of our total traffic across our product is from content product? And do you expect the revenue potential for traffic for the content product to be similar or different from our tools product?

(Spoken in foreign language). My second question is that we notice the competition in overseas market is still very fierce. This quarter, our marketing costs still outstrip our revenue growth. How does the marketing spending outlook look like in the second half? And what is the effectiveness of our marketing spending in terms of customer acquisition cost, retention rate and average revenue per user?

(Spoken in foreign language). The third question is regarding the mobile game revenue has been declining. Can management share some of its thoughts on this business and whether we intend to keep this business? Thank you very much.

Fu Sheng: (Spoken in foreign language).

Andy Yeung: (Interpreted). So in terms of the user (inaudible) for traffic coming from our new content product, they're still pretty low right now because it's new, compared to our very large user base right now, [600 million]. So they also (inaudible) those parts, so the (inaudible) or the traffic from those (inaudible) small. And also monetization is also an opportunity for our content product to be a lot stronger and (inaudible) application as well.

Fu Sheng: (Spoken in foreign language).

Andy Yeung: (Interpreted). In fact, when we look at the contribution from content product, [they] can also especially help us expand our applications' market as well. So if you look at (inaudible) good revenue content user, we would probably have (inaudible) user of our (inaudible) applications.
Andy Yeung: (Interpreted). I'll give you another example. We have a product named called InstaNews in India. It's a news service and [now] it's called News Republic in India, and that product actually has a pretty healthy life -- I'm sorry -- (inaudible) by user. And then if you look at the monetization (inaudible) --

Andy Yeung: (Interpreted). Through monetization, it's actually much stronger than (inaudible) applications (inaudible) it's almost [10] times more monetization rate of our (inaudible) holder.

Andy Yeung: (Interpreted). So if you look at (inaudible) user, the active user, that will (inaudible).

Andy Yeung: (Interpreted). Right. So when you look at our users and cost for these applications, I think if you look at our spending actually in the quarter (inaudible) [a pace that is slower] in recent quarters. Both on a GAAP and non-GAAP basis, it's less than 20% year-over-year. In fact, if you look at it on a quarter-on-quarter basis, you actually see that declining and that (inaudible) our new content product.

So (inaudible) we have shifted from a (inaudible) from our [old usual] applications to the new content product, so I think that speaks volumes to our new applications, their competitiveness, (inaudible) products of our competitors. Our products themselves are not (inaudible) the user not just because we are promoting these applications.

So if you look at the number more closely, you actually see that even though we (inaudible) on the new products, we actually have (inaudible) slowing down the spending on global [advertising] and also (inaudible) costs.

Andy Yeung: (Interpreted). Okay. So your third question regarding the mobile gaming (inaudible) operation, it was (inaudible) in the same quarter for us because (inaudible) versus little games, but they have (inaudible) cycle. We're (inaudible) to roll out our new games, so Rolling Sky, (inaudible) a little game that we (inaudible), we came in the second half of the second quarter. Right now, it's doing quite well, so we're very encouraged by that. So we look forward to having more steady growth in the third quarter.
Eric Wen: Okay, thanks.

Operator: This concludes our question-and-answer session. I would now like to turn the conference back over to Helen Zhu for any closing remarks.

Helen Jing Zhu: Thank you all for joining us today. If you have any questions, please do not hesitate to contact us. Thank you so much. Bye.