Company Participants:
Helen Jing Zhu, Director, IR
Fu Sheng, Chairman, CEO
Vincent Jiang, CFO

Analysts:
Thomas Chong, Credit Suisse

Presentation

Operator: Hello, everyone, and welcome to the Cheetah Mobile Third Quarter 2018 Earnings Conference Call. (Operator Instructions)

Please note this event is being recorded.

I would now like to turn the conference over to Helen Zhu, IR Director of Cheetah Mobile. Please go ahead, ma'am.

Helen Jing Zhu: Thank you, Operator. Welcome to Cheetah Mobile's Third Quarter 2018 Earnings Conference Call. With us today are our Chairman and CEO, Mr. Fu Sheng; and our company CFO, Mr. Vincent Jiang.

Following management's prepared remarks, we will conduct a Q&A section. Our presentation for the company's earnings call is also available at the company's IR website.

Before we begin, I refer you to the safe harbor statement 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 Chairman and CEO, Mr. Fu Sheng. Please go ahead.

Fu Sheng: Thanks, Helen. Hi, everyone. Thanks for joining us today. In the third quarter of 2018, we achieved the high end of our guidance range. Our total revenue grew by 16% year-over-year and 23% quarter-over-quarter to RMB 1.35 billion. We also earned RMB 193 million in non-GAAP net income and generated RMB 326 million in free cash flow.

In the third quarter, we continued to roll out our new mobile games, mobile utility products and AI-powered hardware products. As a result, revenues from mobile games increased by 78% year-over-year and 106% quarter-over-quarter. Revenues from mobile utility products in the domestic market increased by 54% year-over-year and 18% quarter-over-quarter. Mobile games
made up 21% of our total revenue in the quarter, and mobile utility products in the domestic market made up 28%.

Now, I would like to highlight our progress in three areas: one, mobile games; two, mobile utility products in the domestic market; and three, AI-powered hardware products.

First, let me discuss our mobile games business. We soft-launched Bricks n Balls, a classic and exciting block elimination game, early this year. We started ramping it up this quarter with continued in-game improvements, enhanced user interface designs and new content and features. In September, Google Play featured Bricks n Balls on its global homepage. According to App Annie, Bricks n Balls is one of the top three casual games in the U.S. on Google Play and one of the top 10 board games on Apple App Store in terms of user downloads.

Importantly, through our operation of Bricks n Balls, we discovered the right tactics to increase average revenue generated from our mobile gamers. We also continued to use high-quality third-party content to enrich our flagship games, including Piano Tiles 2, Rolling Sky and Dancing Line. In addition, supported by our several individual game studios, we continue to develop new games in our pipeline, which we look forward to releasing in the coming quarters.

In the third quarter, both revenues and profit from our mobile games business hit record highs. This was helped by more users buying in-game items, such as extra lives, "boosters" that enhance play performance, and game version upgrades. In the third quarter, revenues from in-game purchase accounted for 31% of total mobile game revenues, up from 24% last year. We will continue to enhance our in-house game development abilities and pursue various partners to grow this business.

I would also like to emphasize that China's recent gaming regulation changes have a limited impact on our mobile game business. More than 87% of our game revenue and more than 70% of our monthly active gamers are from markets outside of China. Above all, we are optimistic about the growth potential of our mobile game revenue.

Next, let me discuss our mobile utility products in our domestic market. We have expanded the scope of our mobile utility products beyond mission-critical utility apps, adding personalized, AI-driven and other new utility apps as well. One example is our recently launched CM Show, a personalized ring tone app designed to appeal to younger users in China. Along with a custom ring tone, the app also features a wide array of 3D video effects that can also be customized.

CM Show's total daily active user has grown rapidly since its launch, and people born from the middle 1990s to the early 2000s are the most active user group. According to Quest Mobile, CM Show was one of the top five apps in China in terms of daily active user growth in September of 2018. Going forward, we will use our big data capabilities to introduce diversified utility apps that further enrich our mobile utility product portfolio.

In recent years, rising spending power and higher living standards have led to rapid growth of mobile Internet adoption in China's lower-tier cities. In response to the market potential, we have tailored our core mobile utility products to users in lower-tier cities. In the third quarter, daily active users of our mobile utility products like Clean Master continued to grow in our domestic market. This was mostly driven by the growth of active users in lower-tier cities.
As our user base shifts towards young users and users in lower-tier cities, we have new channels for growth. During the third quarter, our monthly active users in the domestic market grew by 17% year-over-year and 6% quarter-over-quarter, reaching a new high of 171 million. Revenues from our mobile utility products in the domestic market grew by 54% year-over-year and 18% quarter-over-quarter.

We began to feel the impact of China's recent economic uncertainty in the latter half of the third quarter. For example, some advertisers cut back on their activities. However, I would like to point out that Cheetah Mobile's position in the Chinese mobile Internet industry is stronger than ever. In recent years, our mobile utility products and apps have had a successful track record in the overseas market. Now, we are repeating our success in China. We have several local partners, with both online and offline channels, to reach more users. Importantly, our utility products business continues to generate strong profit and cash flow, which provides a solid foundation of our investment in new initiatives.

In addition, we have stopped the revenue decline in the overseas market and stabilized the revenues from our PC business. Furthermore -- further, the non-GAAP operating profit for our mobile utility products in the overseas market was more than 40%.

Now, let me turn to our AI-powered hardware business. As stated in the past, our AI-powered hardware business is a joint effort with Beijing OrionStar. So far, Cheetah Translator, the AI interpretation device, has been very well received by the market since it launched in July. It was the top seller among its peer products during this year's JD Double 11 shopping festival. This quarter, we reached a larger customer base by partnering with a couple of well-known retail chains. In the fourth quarter, Beijing OrionStar commercially launched Cheetah GreetBot, a full-size reception robot that focuses on the business-to-business market. Cheetah Mobile is the exclusive distributor of Cheetah GreetBot. Therefore, the sales of these products will directly contribute to our top line. In the coming quarter, we expect to launch more customer-facing AI-powered hardware.

Our AI-powered hardware business is still small in scale compared to our overall revenues, but we believe it will drive our future growth. By combining Cheetah Mobile's expertise in our -- in customer-driven products and AI capabilities of Beijing OrionStar, we will create diverse and innovative products that provide a clear value to our customers.

With that, I will now turn the call to our CFO, Vincent Jiang, to update you on our third quarter financial results.

Vincent Jiang: Thank you, Sheng. Hello, everyone. Now let me walk you through the details of our third quarter performance. Our financial numbers are in RMB unless otherwise noted.

In the third quarter, we continued to focus on rejuvenating our revenue growth. As a result, our total revenues for the third quarter of 2018 grew by 16% year-over-year and 23% quarter-over-quarter to RMB 1.35 billion, meeting the high end of our previous guidance. Particularly, revenue from our mobile game operations increased by 78% year-over-year and 106% quarter-over-quarter to RMB 285 million, which accounted for 21% of our total revenues in the quarter. Revenues from our mobile utility business in the domestic market increased by 54% year-over-
Driven by our accelerated revenue growth, our non-GAAP gross profit increased by 22% year-over-year and 29% quarter-over-quarter to RMB 970 million in the third quarter of 2018. More importantly, our non-GAAP gross margin expanded to 72% from 68% in the same period last year and in the previous quarter.

Non-GAAP operating profit remained flat year-over-year but increased by 8% quarter-over-quarter to RMB 154 million. Non-GAAP operating margin decreased to 11% from 13% in the same period last year and in the second quarter of 2018. The year-over-year decrease in our non-GAAP operating profit was mainly due to more promotional activities for the mobile utility product business in the domestic market and mobile game operations. The sequential increase was due to higher share-based compensation expenses.

In the third quarter, share-based compensation expenses increased by 23% year-over-year and 80% quarter-over-quarter to RMB 26 million as we granted a certain number of restricted shares to our key employees.

While we experienced a decrease in operating profit, the decline was attributed to our added investment in both our mobile utility products in our domestic market and mobile game operations. During the third quarter, both segments became our growth engines.

Despite our continued investment, we generated RMB 339 million net cash from operating activities and RMB 326 million free cash flow in the third quarter. As of September 30, 2018, our cash and cash equivalents, restricted cash and short-term investments totaled RMB 3.6 billion. This strong cash position has allowed us to continue our investments in our AI-powered business, which is an integral component of our long-term growth strategy.

Moving on to the details in each of our reporting segments. Please note that starting on January 1, 2018, Cheetah Mobile adopted ASC 606, the new accounting standard for netting value added taxes out of the line items of revenues and cost of revenues. To increase comparability with the third quarter 2018 numbers, we have adjusted our 2017 revenue numbers net of VAT.

For our utility products and related services business, revenue increased by 4% year-over-year and 11% quarter-over-quarter to RMB 836 million in the third quarter of 2018. The growths were driven by the strong performance of our mobile utility products and related services business in China thanks to the increasing mobile traffic and eCPM in the domestic market.

Revenues from our mobile utility products and related services business in the overseas markets has fully reflected the impact from the discontinuation of ads on mobile phone lock screens and has stabilized during the third quarter. Excluding the impact of the discontinued ad formats, our mobile utility products and related services business in the overseas markets actually increased by 8% year-over-year in U.S. dollar terms. The sequential growth was due to a typical seasonality effect.

In the third quarter of 2018, non-GAAP operating profit for our utility products and related services remained relatively flat year-over-year and decreased by 6% quarter-over-quarter to
RMB 264 million. The sequential decrease was mainly due to increased promotional activities in the domestic market, where we have seen more opportunities for long-term growth.

For our mobile entertainment business, revenues increased by 37% year-over-year and 50% quarter-over-quarter to RMB 498 million in the third quarter of 2018 due to increases in revenues from both our mobile game operations and LiveMe.

In the third quarter, revenues from our mobile game operations increased by 78% year-over-year and 106% quarter-over-quarter to RMB 285 million. The increases were primarily driven by the ramp-up of our new game, titled Bricks n Balls, which we released earlier this year. In addition, revenues from our existing music games, including Piano Tiles 2, Dancing Line and Rolling Sky, continued to grow on both a year-over-year and quarter-over-quarter basis. The growths in our existing titles were primarily attributable to our efforts in introducing creative ad formats and increasing eCPM by working with more mobile advertising platforms and smarter ad algorithms, which are enhanced by our machine learning technology.

Revenues from our content-driven products increased by 5% year-over-year and 9% quarter-over-quarter to RMB 213 million in the third quarter, driven by a new series of features introduced in LiveMe, which further improved its ARPU.

Our operating loss for the mobile entertainment business narrowed to RMB 74 million in this quarter from RMB 105 million in the same period last year and RMB 99 million in the previous quarter. The reduced losses were primarily attributable to an increase in revenues from the mobile game operations.

In the third quarter, non-GAAP operating profit for our mobile game operations increased by RMB 13 million year-over-year and RMB 17 million quarter-over-quarter. In particular, non-GAAP operating profit for our existing mature games already reached 24% in the quarter from 7% in the same period last year. In addition, the year-over-year reduced loss was also due to the reduced cost and expenses from the News Republic business, as we disposed of News Republic in Q4 2017.

Turning to fourth quarter guidance, toward the latter half of Q3, our advertising business, in particular in the domestic market, began to feel the impact of recent regulatory policy changes related to certain verticals, as well as potential macroeconomic uncertainty in China. We expect this trend to continue into the fourth quarter. Our mobile games business is less impacted though, as a large majority of our users are from overseas markets.

Based on the above, we currently estimate total revenues for the fourth quarter to be between RMB 1.39 billion and RMB 1.43 billion.

In addition, Cheetah Mobile has entered into an agreement to sell a portion of its shares of ByteDance, and this transaction will result in a disposal gain of investment of approximately USD 43 million in the fourth quarter of 2018. This transaction will also result in a fair value gain of USD 43 million in the fourth quarter of 2018 for the remaining portion which Cheetah Mobile still holds. This transaction is expected to close by the end of November 2018, subject to customary closing conditions.
In the long term, we expect our mobile games business and our mobile utility products and related services business in the domestic market to be the main growth drivers. These segments will also be our key investment focuses in the coming quarters. We will continue to invest heavily in improving our existing products and developing more new products.

Before we conduct the Q&A session, we would like to remind investors and analysts that on September 13, 2018, the company's board of directors approved a share repurchase program whereby the company may purchase its ADS with an aggregate value of up to USD 100 million over the next 12-month period. The share repurchase plan does not require the company to acquire a specific number of shares. As of yesterday, we had repurchased approximately 1 million ADSes for approximately USD 8 million under this program. The board's decision reflects our belief that buying back our own shares is a good investment for the company.

This concludes our prepared remarks, so operator, we are now ready to take questions. Thank you.

Questions & Answers

Operator: Thank you. (Operator Instructions)

Thomas Chong with Credit Suisse.

Thomas Chong: I have a quick question about our 2019 outlook. Given the fact that the economic situation is not very clear, how should we think about the growth momentum for our different businesses in 2019? And on top of that, how should we think about our margin outlook, given we are more -- also investing more in the smart device business? Thank you. (Speaking Foreign Language).

Vincent Jiang: (Speaking Foreign Language).

Fu Sheng: (Speaking Foreign Language).

(Translated). Okay, first of all, we are pretty confident about the mobile games business in the next year, because in the middle of last year -- actually, in the middle of this year, we have had quite some structural change for the mobile game business. For example, we now are able to rapidly release new games, as compared to our previous business operations. And we have a very strong operating -- excuse me. We have a very strong game operation capability and game publishing capabilities now. For example, what we can see now in the past quarter is the new game, Bricks n Balls, which is one of the hit games we have. But in reality, we have many other games in the pipeline we are testing. As soon as the game testing result is okay, then we're going to release those and promote those games.

Also, because of the game regulations in China, and because of the license issue, they cannot get new games released in China. Mainly game developers in China actually are coming to us and
trying to utilize our platform to launch their games in the overseas market. So actually we are now having a very good pipeline for the future game products.

In addition, we are trying to convert our existing [carrier] game into a relatively more complex game in a way that they can generate more revenues. For example, we are now having more and more in-game purchase capabilities, which increased our monetization capability, because in the past we were doing a lot of monetization through advertising only.

In addition, our existing mature games, such as Piano Tiles 2, Rolling Sky, those are performing very well.

Fu Sheng: (Speaking Foreign Language).

(Translated). Okay, just add one more thing. So previously we might think that the lifespan of our [carrier] games are kind of short, but in reality, they are actually very long. For example, for Piano Tiles 2, it has been operating for more than three years, and its revenue are still continuing to hitting record highs. And its margins are also improving greatly. When we're looking at that, we are continuing to release a new version of the old games, in a way. For example, we have been releasing -- we have been testing a new version of Rolling Sky. We call it Rolling Sky 2. And it has been -- we have received a lot of positive feedback from our users and we plan to release that game soon.

Fu Sheng: (Speaking Foreign Language).

(Translated). Okay, we're also very optimistic about our utility products. Even though our system utilities products such as Clean Master, for those type of products, we are no longer aggressively acquiring new users, but we are developing and launching new products. For example, the new utility products we just released called Cheetah -- CM Show, excuse me. CM Show. It is one of the personalization products. We are also having other -- quite a few other personalization utility products and lifestyle type of utility products, and some products which are powered by AI technologies. So we are pretty confident about that as well.

Fu Sheng: (Speaking Foreign Language).

(Translated). So we will call those businesses our traditional business. We are confident about their continued -- the growth, and -- yes, please.

Fu Sheng: (Speaking Foreign Language).

(Translated). For the smart hardware products, we all know that we will need some investment in the early stage, but we are focusing on AI products to consumers. For those type of products, we're not competing head to head with those popular products such as (inaudible), but we are trying to get into that market through other peripheral products such as AI Translator, which we launched in July, yes. And which -- it is actually the No. 1 seller in this category right now.

Fu Sheng: (Speaking Foreign Language).

(Translated). Okay, for our robotics product, this is our more facing business. We are trying to
provide solutions for particular industries, and so that's not a business that burns money quickly, and it's more to develop our ability to create a new business with -- create new opportunities with businesses.

Operator: (Operator Instructions). As there are no more questions at the present time, I would like to turn the call back over to Helen Zhu for any closing remarks.

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

Operator: This concludes this conference. Thank you for attending today's presentation. You may now disconnect.