

Cheetah Mobile, Inc. [CMCM]
Q4 and Full Year 2018 Earnings Conference Call
Monday, March 25, 2019, 8:00 AM ET

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

Analysts:
Frank Chen, Macquarie
Robert Cowell, 86Research
Carson Lo, Nomura
Unknown Analyst, Credit Suisse
Hillman Chan, Citigroup

Presentation

Operator: Good evening, and welcome to the Cheetah Mobile fourth quarter and full year 2018 earnings conference call. (Operator Instructions). After today's presentation, there will be an opportunity to ask questions. (Operator Instructions). Please note this event is being recorded.

I would now like to turn the conference over to Helen Zhu, Investor Relations Director. Ms. Zhu, please go ahead.

Helen Jing Zhu: Thank you, Operator. Welcome to Cheetah Mobile's fourth quarter and full year 2018 earnings conference call. With us today are our Chairman and CEO, Mr. Fu Sheng, and our Company's CFO, Mr. Vincent Jiang.

Following management's prepared remarks, we will conduct a Q&A session. 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 Company's Chairman and CEO, Mr. Fu Sheng. Please go ahead, Fu Sheng.

Fu Sheng: Thanks, Helen. Hello, everyone. We achieved full year 2018 financial results that were in line with our previous expectations.

Total revenues increased by 2% to RMB5 billion in 2018. In particular, revenues from mobile games operation increased by almost 50%, and revenues from utility products and related services in the domestic market grew by 22% for the full year 2018.

Non-GAAP operating profits for the utility products and related services increased to

RMB1 billion in 2018, and we further reduced our operating loss from the mobile entertainment segment in 2018.

Above all, our core business generated RMB342 million of net cash from operating activities and RMB277 million of free cash flow in 2018.

Our business progress and financial achievements in 2018 were mostly driven by growths in the following three areas: one, mobile games; two, mobile utility products in the domestic market; and three, AI-powered business.

First, we made significant progress in our mobile game operation, which has already become a driving force of our total revenue. In 2018, our mobile games business earned RMB925 million in revenues, up 48% from 2017.

We successfully launched Bricks n Balls, a casual elimination game. Bricks n Balls remained one of the top mobile casual games in the U.S. and on Google Play, and one of the top board games on Apple's App Store in terms of user downloads. Through operating Bricks n Balls, we have discovered the right combination of tactics to grow our average revenue per mobile gamer. Bricks n Balls had a higher ARPU than Piano Tiles 2, Rolling Sky and Dancing Line in the second half of 2018.

Moreover, almost half of the revenues from Bricks n Balls were generated through sales of in-game virtual items. In late February, we soft-launched Rolling Sky II, a musical game, on Apple's App Store. In early March, Apple featured Rolling Sky II, ranking it as a top free game, as well as specifically promoting it in the musical game vertical on Apple's App Store.

Importantly, we increased the operating profits for our mobile game business in 2018. For example, the combined operating profits for our three flagship titles, namely, Piano Tiles 2, Rolling Sky, and Dancing Line, grew by about 200% year-over-year in 2018. And their non-GAAP operating margin increased to 25% from 10% in 2017.

Going forward, we will continue to introduce new games, convert more of our gamers to paying users, and further enhance the profitability of our mobile games business.

Secondly, we introduced some new utility products in the domestic markets in 2018, which has helped increase our user engagement and expand our user base. Our new utility products focus on a number of areas, including delivering personalized experiences, and leveraging our AI technology.

For example, we introduced the CM Show, a personalized ring tone app designed to appeal to generation Z in China. The app has received widespread user adoption since its inception. More recently, we began adding premium content into CM Show to induce more user subscriptions. Although CM Show is still in its early stage of monetization, many users are willing to pay a small amount to gain access to premium content, thus proving its commercial viability.

We also introduced Qu Keyboard, an AI-driven keyboard, last year, late last year. In addition to smart prediction capabilities, voice input, and thousands of themes, Qu Keyboard comes with a gamified user loyalty program that allows users to earn virtual coins through typing and other in-

game activities. Users can then use their earned virtual coins within our apps to buy in-game virtual items, pay monthly subscription fees for specific online video platforms, and order other online services and products.

According to QuestMobile, Qu Keyboard was one of the top rising star mobile apps in 2018. Going forward, we will continue to introduce new utility apps that can further enrich our mobile utility product portfolio.

Importantly, our utility product business continued to earn healthy revenue and profits. In 2018, we earned RMB3 billion in revenue and RMB1 billion in operating profit from our utility product business.

Thirdly, we began offering AI-powered hardware in China in 2018, which has allowed us to serve more users and customers in the new era of human-computer interaction. Our hardware business is a joint effort with Beijing OrionStar.

Revenues from our Other business segment increased to RMB83 million in 2018 from RMB37 million in 2017, mainly driven by the sales of our AI-powered hardware in China.

In particular, this growth was mainly driven by the sales of Cheetah Translator, an AI-based interpretation device. Recently, we have found more use cases for Cheetah Translator to serve businesses. For example, VIPKid, an online educational company, purchased a large quantity of Cheetah Translators to help its young students learn English.

Uroaming, an overseas WiFi service rental platform, also bought a number of Cheetah Translators to enrich its product offerings.

Cheetah Translator marks an important milestone of our expansion into AI-based products and solutions. The success of Cheetah Translator helps us further improve our AI technologies and our capabilities to deliver AI-based solutions to customers and businesses.

Also, in 2018, Cheetah Mobile became the exclusive distributor of Cheetah GreetBot, a human-sized reception robot that focuses on the business-to-business market. In December 2018, Beijing OrionStar commercially launched Cheetah GreetBot. Recently, we have also found more use cases for Cheetah GreetBot to serve customers in diverse verticals in China, including as guides in museums, receptionists in hospitals, schools, and salespersons in convenience stores.

Although our AI-powered hardware business is still in its infancy in terms of revenue contribution, we believe it will become an important engine to drive our future growth, as we proactively prepare for the new era of human-computer interaction.

In summary, we have made substantial progress in mobile games, mobile utility products in the domestic market, and our AI-powered business. We are confident that our long-term growth prospects remain healthy, although we acknowledge some temporary setbacks in our mobile utility product business in the overseas markets.

With that, I will now turn the call to our CFO, Vincent Jiang, to go through the details of our fourth quarter financial results.

Vincent Jiang: Thank you, Fu Sheng. Hello, everyone. In the fourth quarter of 2018, we grew our total revenues by 2% year over year and quarter over quarter to RMB1.4 billion.

We generated RMB770 million in net income attributable to Cheetah Mobile shareholders. For the full year of 2018, we generated RMB5.0 billion in total revenue and RMB1.2 billion in net income attributable to Cheetah Mobile shareholders.

Now, let me walk you through the details of our fourth quarter and full year 2018 financial results. Please note that all financial numbers are in RMB terms unless otherwise stated.

Revenues from our mobile entertainment business increased by 39% year over year and 12% quarter over quarter to RMB556 million in the fourth quarter of 2018. For the full year of 2018, revenues from our mobile entertainment business increased by 19% to RMB1.8 billion, mainly driven by Bricks n Balls, a casual elimination game that started ramping up in the middle of July 2018.

Revenues from our mobile games operation increased by 91% year over year and 14% quarter over quarter to RMB326 million, which accounted for 24% of our total revenues in the fourth quarter of 2018. For the full year of 2018, our mobile games business generated RMB925 million in revenues, up 48% from 2017.

Revenues from utility products and related services decreased by 17% year over year and 6% quarter over quarter to RMB783 million in the fourth quarter of 2018. The year-over-year decrease was mainly due to the discontinuation of certain ad formats, which is ads on mobile phone lock screens, by the Company's overseas third-party advertising partners.

The quarter-over-quarter decrease was mainly due to the disruption to our business as a result of certain allegations made by a third party in November 2018, about which the Company has made a number of public statements to clarify.

For the full year of 2018, revenues from utility products and related services were RMB3.1 billion.

Gross profit and gross margin both increased year over year. In the fourth quarter of 2018, gross profit grew by 4% year over year to RMB965 million, and gross margin expanded to 70% from 68% in the same period last year. For the full year of 2018, gross profit increased by 8% to RMB3.4 billion, and gross margin expanded to 69% from 66% in 2017.

The increase resulted from the reduced costs for our PC operations and mobile utility products business in the overseas markets as part of our strategy to optimize the cost and expense structure for our utility products and related services business.

We grew both our operating profit and margin in 2018, despite our continued investment in our mobile games business and mobile utility products business in the domestic market.

Operating profit for the full year of 2018 increased by 5% to RMB467 million, while our operating margin remained relatively flat year over year at 9%.

In 2018, we continued our marketing efforts to acquire new users for our mobile games in the overseas markets, and for our mobile utility products in the domestic market.

Our mobile entertainment business reduced its loss in 2018. For the full year of 2018, operating loss for the mobile entertainment business narrowed to RMB313 million from RMB417 million in 2017.

The reduced losses were primarily the result of increased revenues from our mobile game operations. In addition, the disposal of the News Republic businesses in 2017 also contributed to the decreased operating loss for our mobile entertainment business.

In particular, the operating profit of our mobile games business grew by 48% in 2018.

Our core business continued to generate strong cash flow. For the full year of 2018, we generated RMB342 million in net cash from operating activities and RMB277 million in free cash flow.

We sold a certain portion of our equity ownership in Bytedance Ltd., which further strengthened our earnings and balance sheet.

Diluted earnings per ADS was RMB8.10 or US\$1.18 in 2018.

As of December 31, 2018, our cash, cash equivalents, restricted cash, and short-term investments were RMB3.7 billion.

As we have previously disclosed, on November 26, 2018, a third party made certain allegations about some of our products, which later led to a pause in our collaboration with some of our business partners in the overseas market.

As the allegations are the subject of pending litigation, we are not going to comment extensively on this. But we believe that the claims in the litigation are without merit, and we intend to defend ourselves vigorously.

The Company is addressing these allegations with our business partners, and the Company's audit committee is conducting an independent review of the allegations in consultation with our outside counsel at Skadden Arps and experts from AlixPartners, which is an outside consulting firm. To date, the company has not identified information inconsistent with its previous disclosures.

All of our board of directors swift and decisive actions are a testament to our Company's commitment to legal and regulatory compliance.

Before I give you our revenue guidance, I would like to remind you that this forecast reflects our current and preliminary views, and is subject to change.

For the first quarter of 2019, we expect our total revenues to be between RMB1.06 billion and RMB1.09 billion, as we take a conservative stance on our near-term outlook following the temporary setbacks in our mobile utility products business in the overseas markets. However, we remain confident in the long-term sustainability of our growth prospects.

To express our confidence in our long-term growth prospects, our board of directors has approved a share repurchase program of up to US\$100 million of our outstanding ADSs for a period not to exceed 12 months, as previously announced on September 13, 2018.

As of March 22, 2019, the Company had repurchased approximately 4.5 million ADSs for approximately US\$32 million under this program. Cheetah Mobile funded those repurchases from its available cash balance.

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

Questions & Answers

Operator: Thank you. We will now begin the question-and-answer session. (Operator Instructions). For the benefit of all participants, if you wish to ask your question in Chinese, please immediately repeat in English. Wendy Huang with Macquarie.

Frank Chen: This is Frank Chen with Macquarie on behalf of Wendy Huang. I basically have two questions. One is on the first quarter guidance. Could management share with us more color on this set of guidance, especially first quarter revenue breakdown by different business segment?

And the second question is about full year outlook into 2019. Could management share any thoughts on the full year revenue growth in 2019 and the margin outlook in this year?

Vincent Jiang: Okay. I'll take that question.

Fu Sheng: Okay.

Vincent Jiang: First of all, in terms of the revenue guidance, yes, it is -- there's a sequential and year-over-year decline in the guidance. The main reason -- and actually, we have explained in the prepared remarks -- is because of the allegations made by a third party in November 2018, that has caused some of our business partners to pause their relationship with us. So that has a direct impact on overseas utility products. But as we said earlier, we're working with those business partners to address their concerns.

And the Company has also retained -- the Company's audit committee has retained outside legal counsel, Skadden Arps, and also has -- Skadden Arps also has in turn engaged outside consulting firm, AlixPartners, which is a well-known consulting firm in the U.S., to do the internal review for the -- and to -- related to allegations. And as of today, Skadden and AlixPartners has not identified any issues that's inconsistent with our previous disclosure.

So that explains the reason for the weak first quarter guidance, but we are very confident that we shall be able to address those different partners' concern going forward. Yes, for the full year guidance, again, I think for the -- again for the overseas utility products, probably we will have

some setbacks, as we mentioned earlier, because of that reason. I think it is something we're still working with our business partners, but for other part, we expect that our -- there will be the new business driver, which is the mobile games. It is the new driving force for Cheetah Mobile and we have high expectation on that new area.

Also, I think more importantly, we are starting to materialize our AI investments for the -- especially for the hardware parts. For example, we have started to -- we have had a certain commercial success, although it's relatively small in terms of our scale right now. But the Cheetah Translator is a milestone that we have achieved, that actually that's one of the first hardware we have launched in the past several months because Cheetah Mobile was a software company; it doesn't have the gene for hardware.

So now we have transformed ourselves into a company that has been strategically focused on AI hardware and also we have already made a lot of progress in this area. With the AI Translator, we have already achieved a certain milestone in this area.

And I think also we have been functioning as OrionStar's exclusive distributor for the Cheetah GreetBot, which is an AI robot that can function as -- for different scenarios actually. In the prepared remarks, the CEO of the Company had mentioned that in different scenarios, for example, in hospitals, in supermarkets, convenience stores, that we are -- we have all find different applications for the Cheetah GreetBot. So although this is still -- it's in early stage, but we have seen a lot of promise in these new areas. And we will see some revenue contribution from the AI hardware for full year 2019.

In terms of profitability, at this stage, well, I can't -- we normally don't give forecast on profitability, on profit. But based on general guidance here, I think because of the overseas utility products, we have some -- we saw disruption here. So it does impact first quarter and probably Q2 as well. And so I think in this part, the profit margin on this segment will be lower than last year. And also for the hardware part, because it's still in the relatively early stage, and we don't expect that will bring up a very high profit margin. So the overall profit margin will probably be lower than last year, than 2018.

But again, I said I think this is a good transition for us. We are in the process of transforming ourselves from a pure software company into a company that has combined software and smart hardware.

Okay, Frank, hope I have answered your questions.

Frank Chen: Thank you, very clear. Thanks a lot.

Operator: (Operator instructions). Robert Cowell with 86 Research.

Robert Cowell: Thanks for taking my question; I just have two. The first one is about the MAU number. How do we think about -- it seems to be down a bit on a quarter-on-quarter basis. How are we thinking about MAU going forward and balancing MAU versus ARPU?

And then the second question is about Beijing OrionStar and its fundraising plan. Will Beijing OrionStar seek to waive funds from third parties or it will -- does Cheetah plan to invest more in

that company at some point in 2019? Those are my two questions.

Vincent Jiang: Okay. I'll take the first question in terms of the monthly active users. Yes, the number is lower than we reported last quarter, and one of the main reasons is because of also that's related to the temporary disruption to our overseas utility product, because of the monetization side of this.

So we feel that -- we decided that we are -- we kind of temporarily pulled back our user acquisition efforts in this quarter. So I think that's why you can see a quite -- a relatively noticeable decline in MAUs, but we expect that when everything goes back to normal, I think the number will come back again.

In terms of OrionStar, in terms of fundraising plan for OrionStar, unfortunately, it is something -- it's not something that we can discuss in public. Of course, there will be some plans that the Company is open to all sorts of possibilities, but right now, we cannot have any -- we cannot say any definitive plans at this moment.

Robert Cowell: Okay. Understood. Thank you.

Operator: (Operator Instructions). Carson Lo with Nomura.

Carson Lo: So one question about advertising market outlook. So we've seen that the macro for both China and overseas, maybe U.S., so facing some kind of slowdown since the fourth quarter. So does management think -- can management share some color on how could that impact our advertisings on our product, both on the utility side and also on our mobile gaming side?

Vincent Jiang: In terms of the -- I think the macro economy does have an impact on the advertising industry, but at this stage, I think it's very -- I think for us, it's not very clear in the internal or general trend. For example, within -- in China's market, there have been different -- I think different views right? In last year, I think the last year, at the end of last year, people were relatively pessimistic about the general macro economy, but I think already this year, we have seen some positive signs. So we don't have a definitive sight just as yet in terms of whether that will have a positive or negative impact on the advertising industry.

In the overseas markets, they will -- yes, I think they will probably have some impact. But I think the overall industry, there probably will be some change under the new regulatory regime. So we are still carefully following the trends; I mean, we're carefully following the latest development in terms of the regulatory environment, but again, we don't have a definitive view on this.

Carson Lo: Thank you.

Operator: Ribery Gu with Credit Suisse.

Unknown Analyst: This is Ribery speaking on behalf of Thomas. We basically have two questions. The very first question is about the -- as to revenue mix -- as we see the revenue mix is changing, as mobile game is generating more and more revenue, are we going to see probably a clearer trend for the gross margin profile change in 2019?

Secondly is that management mentioned about the temporary suspension of the business relationship with overseas business partners. Can management -- given that management has already done some work on that issue, can management give us some guidance whether the temporary suspension will become normalized?

Vincent Jiang: Okay. Again, I'll take the question. The first one in terms of the revenue mix, yes, the mobile game business has become an increasingly large part of our total revenues. And I think we expect this trend will continue because we have been able to identify some very scalable business operations that can help us to launch more games in a relatively shorter period of time.

In terms of the total profit margin for the games, I can say right now is that the existing games like Piano Tiles 2, those more mature games have very good profit margin. I think for 2019, we will be in the expanding mode for the game operations. So we will probably -- in the early stage, we will have a relatively large portion of marketing and new acquisition cost. So the overall profit margin will -- I don't see -- well, probably will not be better than what we have already.

In terms of the business relationship with our -- the relation with our business partners, we -- this is something we are still working with, and we are very positive. We have seen some positive signs of recovery soon, but at this stage, I cannot give you a definitive answer.

Ribery Gu: Thanks, management.

Operator: Hillman Chan with Citigroup.

Hillman Chan: My first question is related to the game pipeline. Could management share more color on our game development effort as to what kind of games that we're developing, and in what game genres, and more color on the timeline would be helpful as well.

And another question would be on the AI hardware side. How should we think about the profitability currently and also for the longer term?

Fu Sheng: (Speaking Foreign Language).

(Translated). Okay. In Q3 and Q4 last year, we have accumulated quite some new games, for example, one of the top games in China called Kill Virus. We have become the exclusive distributor in the overseas markets. So we have more than 10 games -- some of those are very promising -- in our pipelines right now.

Fu Sheng: (Speaking Foreign Language).

(Translated). More importantly, we think that the casual games actually have a very long lifecycle. For example, Piano Tiles 2, which has been around for more than 3 years, is still generating very stable revenue for us. And some of those games have become -- already become intellectual properties that have been recognized by many people.

Fu Sheng: (Speaking Foreign Language).

(Translated). Yes, we also have done a lot work to improve the ARPU of the casual games. For example, those games have been released by somewhere between 3 to 6 months or more than that, longer term. We call it mature games and those games have pretty good margins.

Operator: (Operator instructions).

Vincent Jiang: Actually, and I'll take the second part -- the second question in terms of the profitability of the AI hardware. I think at this stage, it's still relatively early for Cheetah Mobile to move into the hardware business. The hardware margin initially will not be very good actually, we have to admit, because the volume at this stage has not been -- has not reached what we expected.

But for the second part, for the AI --

Fu Sheng: (Speaking Foreign Language).

Vincent Jiang: Yes, that's for the consumer side, right, but for the profitability of the GreetBot, which is to business -- that's the product for business. At this stage, we think they -- we expect they will be relatively healthy when we reach certain volumes. But again, at this stage, it's probably too early to say because we're still ramping up the volume at this stage.

Hillman Chan: Thank you very much.

Vincent Jiang: Right, yes, of course, for single units, we expect we will have appropriate allocation about the production costs and our other costs; they can be pretty healthy.

Hillman Chan: Thank you.

Operator: Robert Cowell with 86 Research.

Robert Cowell: I'd just like an update on -- if we can provide any metrics for the volume of GreetBot that you all are shipping or planning to ship in the near future.

And then also there were a number of other AI robotics products that you all announced last year, and I'm interested if any of those other ones you have updates that you're willing to share?

Fu Sheng: (Speaking Foreign Language).

(Translated). Okay. So we actually launched the product, GreetBot, last December, and we have a spring break in between. And so we don't have actually a lot of time to implement those. Also, we have been using a lot of our distributors who will do secondary development for the actual applications for any particular scenario, so that also takes some time. That's why, at this stage, we do have some volumes, but they're not as significant yet, but we do see a lot of promising signs at this stage.

Fu Sheng: (Speaking Foreign Language).

(Translated). Yes, again, we have seen some very promising signs in some customers. We have

some returning customers as well where they bought something -- they bought some GreetBot, and they use it and they are likely to come back to buy more. We have seen -- we have found -- actually found the real cases that GreetBot actually can help a lot and save labor costs in many situations, for example, in museums and in convenience stores.

So that's the translating, but let me add a little bit more details in terms of the actual scenario. For example, in the museums, our GreetBot can function as a tour guide. They will explain -- it will now give introductions to various art pieces in the museums. It has very high user interaction levels. For example, it can -- hundreds of interactions with different people that will - we can see that one robot can easily replace one human being. But for more people in more in our situation can replace up to 3 people in terms of the amount of interaction it can provide.

And in some -- in one scenario is the convenience store; we have a convenience store chain. They bought one; they did some secondary development on it, so they kind of customized that robot in their stores. Then they're likely to come back, buy 10 of those, and then they put it in different locations.

So in the night in this store, normally they would have required two people, but now they can have only one person in the store and have the robot actually patrolling in the store moving around. And they can function very well actually, and apparently the -- the convenience store chain, they have seen the values and they are doing a lot of more applications using those robots.

Robert Cowell: Thank you.

Operator: (Operator Instructions). As there appears to be no further questions, I would now like to turn the conference back over to management for any closing remarks.

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

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