

[CMCM] - Cheetah Mobile, Inc.
Third-Quarter 2017 Earnings Conference Call
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Officers

Ms. Helen Jing Zhu; Director, IR
Mr. Fu Sheng; CEO, Director
Mr. Vincent Jiang; CFO

Analysts

Thomas Chong; Credit Suisse
Joyce Ju; Citibank
Wendy Huang; Macquarie Group
Robert Cowell; 86Research Limited

Presentation

Operator: Good day and welcome to the Cheetah Mobile third-quarter 2017 earnings conference call. (Operator Instructions) Please note this event is being recorded.

I now would like to turn the conference over to Ms. Helen Zhu, the IR Director of the Company. Please go ahead.

Helen Jing Zhu: Thank you, Operator. Welcome to Cheetah Mobile's third-quarter 2017 earnings conference call. With us today are our company's CEO, Mr. Fu Sheng, and Mr. Vincent Jiang, our company's 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 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 Sheng: Thanks, Helen, and hi, everyone. Our overall businesses remained healthy in Q3 2017. Our revenue remained stable, while our profit and free cash flow continued to improve. Year to date, we made RMB3.6 billion in revenue, RMB371 million in non-GAAP net income and RMB336 million in free cash flow. In fact, we had higher non-GAAP net income and free cash flow in the first nine months of 2017 than we did in the full year of 2016.

Now let me give you more details in each of our business lines.

Our utility products remain popular among users. Clean Master maintains the highest rating on Google Play. More than 100 million users access the app everyday and more than 30 million users have given it a 5-star rating. CM Launcher remains a top personalized app on Google Play in the US and Security Master once again topped the latest test of Android security by AV-TEST.

Revenues from our utility products and service remained stable this quarter, thanks to our large global user base. In the past years, our revenue grew rapidly as smartphones became popular in developed countries. Such growth slowed down as mobile apps markets in these countries became mature. We have also built a large user base in emerging markets over the past years. However, the online industry in these markets still lags well behind that of developed countries. We believe that with fast economic growth and the shift from traditional media to online media, the time for larger revenue from emerging markets will come.

In the domestic market, our mobile utility products and the service business has been growing. In this quarter, revenues from our domestic utility apps grows by 35% year over year and 24% quarter over quarter. We believe this growth change will continue in the coming quarters.

In addition, we have continued to optimize cost and expense for our utility products and related service. As a result, our non-GAAP operating margin from our utility products and the related service expanded to 32% in this quarter, up from 24% in the same period last year and 26% from the previous quarter.

Both revenue and profits for our mobile game business continued to grow in the third quarter. We further strengthened our game portfolio to serve our nearly 100 million monthly active gamers around the world, which will allow us to further grow our gamer base going forward. We are also encouraged by the fact that our casual games have longer life cycles than we had previously thought. For example, Piano Tiles continued to generate significant revenues with its large user base though it has been in the market for over two years. In addition, we have made progress in turning casual gamers to higher quality users for our mobile casual games.

Our Live.me app remains the top grossing social app on Google Play in the US. It is also a top app on Apple's App Store. In addition, Live.me reached US\$50 million in its round B financing this November.

To accelerate our content strategy overseas, we have recently established a strategic alliance with Bytedance, or Toutiao. While our personalized news delivery has huge market potential, many internet giants such as Facebook and Google started to join in overseas. With Toutiao, a leading AI-powered content platform, we will enhance our first-mover advantage overseas and grow our ability to monetize our utility products. Also selling News Republic to Toutiao can help us focus more on our AI strategy.

Over the past year, we made large investment in AI. This helps us better understand and assess our users. In Q3, we solidified our leading AI by investing in Beijing OrionStar, an AI tech

company. We believe that a game changer in the industry is to apply AI to products and services to meet user needs. As a result, we are using advanced AI technology to enhance products and service. I'd like to share some examples with you.

First, we've used AI to strengthen our mobile targeting capability in China. As a result, our eCPMs for result pages grew much in China which in turn helped our mobile ad revenue reached a record high this quarter. In addition, our improved ad tech has attracted more advertisers in key markets such as ecommerce, online services, [autos] and fintech.

Second, we have used facial recognition to better reveal real-time video content from Live.me users. As a result, our workload and the labor costs for Live.me have reduced greatly.

Third, we will add AI to Cheetah Keyboard which can now predict user intent, suggest replies and enable users to type faster on mobile. In the quarter, Cheetah Keyboard was featured by Google Play on its global homepage. AI has boosted our ability to mine data and let us process a large and a mixed amount of language data in real time. As a result, we will be able to deliver more targeted content to our users and further grow our lead in the global utility space.

Our nearly 600 million global mobile MAUs have laid a solid base for our goals in AI. In turn, our AI tech has led us to better understand our users and create more offering [from] them, such as new mobile casual games, live streaming, short-form videos and news. At the same time, our ability to deliver AI-driven targeted content will help us push more relevant content to our users which bring our global distribution power to the next level.

Our 30% equity interest in Beijing OrionStar also grows our AI ability. It provides us Orion OS, a voice-based operating system that allows a smart device to pick up direct voice commands even in a loud background. Orion OS is best known for its natural and pleasant voice when it talks. It also has many skill sets such as playing music, playing online audio files and giving updates on news and weather. We believe voice-based operating systems will become a new gateway for mobile users. It also is an entry point into a major market that is new in China.

In China, OrionOS have several well known [user base]. For example, Beijing OrionStar created the Xiaoya AI speaker with Ximalaya, a popular podcast-sharing platform in China. Xiaomi has applied Beijing Orion OS AI to Xiaomi's AI speaker and the Xiaomi TV. Also, Beijing OrionStar is working with a number of partners such as Tencent, Xiaomi to create more AI driving software and hardware products in the coming quarters.

In short, we continued to carry out our strategy of better serving our nearly 600 million mobile MAUs, creating more offerings for them and growing their engagement and time spent on our products.

With that, I will now turn the call to our CFO, Vincent Jiang, for Q3's financial updates.

Vincent Jiang: Thank you, Fu Sheng. Hello, everyone. I am pleased to announce that our overall financial performance was strong in the third quarter of 2017.

Our total revenues were robust and our profit and free cash flow continued to improve. Non-GAAP operating profit increased by 303% year over year to RMB154 million and non-GAAP net income grew by 123% year over year to RMB161 million, hitting a record high. Free cash flow increased to RMB192 million from a negative free cash flow of RMB99 million in same period last year. This strong performance lays a solid foundation for our ambitions in artificial intelligence technologies.

Now let me walk you through the details of our financial performance. Please know that all financial numbers are in RMB unless otherwise noted.

Our total revenues increased by 6% year over year to approximately RMB1.2 billion in the third quarter of 2017. The increase was led by growth in our Live.me and mobile game businesses.

Moving to each of our business lines, to our utility products and related services, revenues decreased by 15% year over year to RMB825 million in third quarter of 2017. The decrease was primarily due to the decline in PC revenues as internet traffic in China continued to migrate from PC to mobile.

In the quarter PC revenues decreased by 37% year over year to RMB144 million. Revenues from mobile utility products and related services decreased by 7% year over year to RMB688 million due to a decline in impressions [in overseas markets]. As we mentioned in the earnings call for Q2, certain ad formats were discontinued by one of our overseas third-party advertising partners in mid-Q2 and the resulting ad inventory were not fully filled by our other advertising partners.

However, mobile revenue contributions from our domestic market hit a record high in Q3. We have leveraged AI to strengthen our mobile targeting capability, which helps eCPM improve. Our mobile MAU also expanded in China, which increased by 20% year over year to RMB145 million during the quarter. In addition, we have diversified our source of revenues overseas. Revenues from Facebook decreased to 9% of our total revenues in Q3 2017 from 19% of our total revenues in same period last year. At the same time, the aggregated revenue contribution from Google, Yahoo and Twitter increased to 21% of our total revenue from 15% in the same period last year, representing a net increase in revenue of over RMB87 million.

Non-GAAP operating profit for our utility products and related services increased by 14% year over year to RMB260 million in third quarter of 2017. Non-GAAP operating margin for our utility products and related services increased from 24% in the same period last year to 32% in this quarter. The increase was the result of our strategy to continue to optimize the cost and expense structures for our utility products, limited our marketing dollars to our core products in key markets, and improved our sales forces' efficiencies. These efforts, coupled with the resilient revenues, have allowed our utility products and related services business to improve profitability and generate a strong cash flow.

For our mobile entertainment business, revenues increased by 124% year over year to RMB362 million in the third quarter of 2017. Specifically, revenue from our content-driven products increased by 299% year over year to RMB202 million in the third quarter of 2017. Live.me, a popular live video-streaming app serving overseas users, remained the vast majority contributor of our content revenues.

Revenues from our mobile game business increased by 44% year over year to RMB161 million in the third quarter. The growth was mainly due to our efforts to introduce more casual games early this year. At the same time, we have introduced in-game purchases to provide innovative features to our users, thus enhancing users' game experience. For example, the paying user count on our game Tap Tap Fish increased by 150% sequentially in Q3. In addition, some of our mobile games have gained popularity in China. For instance, Rolling Sky has been a Top 3 board game in China on Google Play since July 2017.

Our non-GAAP operating losses for the mobile entertainment business shrank year over year from RMB190 million to RMB105 million. The narrowed loss was primarily driven by year-over-year revenue increase in the Live.me and mobile game businesses. In addition, we reduced expenses related to News Republic business.

Moving to our balance sheet, we have a very healthy balance sheet. As of September 30, 2017, our cash, cash equivalents, restricted cash and short investments were RMB2.4 billion. Our long-term investments were RMB1.1 billion, which includes several well known mobile companies that we invested during their early round of fundraising. In the third quarter we gradually disposed of some of our noncore companies, which not only strengthened our cash position, but also boosted our earnings.

A few days ago we announced the acquisition of Musical.ly by ByteDance, or Toutiao. Cheetah Mobile was an early investor of Musical.ly and held approximately 17% of equity interest in the Company on a fully diluted and as-converted basis as of the end of last year.

In addition, we are going to sell News Republic to Toutiao for US\$87 million. As a result, we will start to deconsolidate News Republic's related financials after its closing.

We would now like to provide revenue guidance. For the fourth quarter of 2017 we expect total revenues to be between RMB1.25 billion and RMB1.31 billion. Please note that this forecast reflects our current and preliminary views and is subject to change.

Overall, our utility products and related services continue to generate strong levels of profit and cash flow, which paid off our previous investments and laid a solid foundation for our ambitions in AI technologies. At the same time, we are optimistic about growing our Live.me and mobile game business in the long term.

This concludes our prepared remarks. Operator, we're now ready to take questions.

Questions and Answers

Operator: (Operator Instructions) The first question comes from Thomas Chong of Credit Suisse.

Thomas Chong: (Speaking in Chinese)

(Inaudible) translate my questions in English. First, congratulation on the cooperation with Toutiao. I just want to get a sense of our overseas strategy with Toutiao with regard to content as well as the monetization side.

And my second question is about our 2018 revenue and margin outlook, if there's any. Thank you.

Fu Sheng: (Speaking in Chinese)

Vincent Jiang: Okay, let me translate the answer.

As translated: On the first point, the strategic alliance with Toutiao (inaudible) strengthens our cash reserve.

The second point is that because Toutiao has done many years of personalization in content delivery services, so with the strategic alliance and we expect it to combine their content into our [ours]. So that can provide access to millions of -- hundreds of millions of our users globally. So we expect that will help our revenue growth.

And third point is that Live.me has certain rights that if Toutiao wants to have a certain business cooperation in overseas markets with third-party live streaming business, then Live.me has the priority to provide that kind of service.

So we expect that the overall strategic alliance will be a win-win situation for both companies. Thank you.

Vincent Jiang: Let me take the second question about the overall outlook of the business in 2018. For this part we expect that the utility products and service will remain stable in 2018 and we expect that it will generate healthy profit and cash flow in 2018 as well.

For the mobile entertainment business, we expect that our game -- the casual game business and Live.me will continue to have revenue growth in 2018. We expect that the profitability of the casual games will probably improve because we are expecting to have more in-game-purchase

features to included in our casual games. And we certainly will expect that the current loss in Live.me will narrow in the near future. Okay, thank you.

Thomas Chong: Thank you.

Operator: (Operator Instructions) The next question comes from Joyce Ju of Citibank.

Joyce Ju: (Speaking in Chinese)

As translated: I would like to translate my own questions. My first question is regarding the mobile games. Given the Company has introduced that they are going to grow their in-app -- or in-game purchased (inaudible) so we would like to get more colors in terms of the Company's strategy and potential financial scale on that part of revenue.

My second question is related to the utility products profitability. We have seen the profitability continue to improve. Wonder, do you have find more disciplined expenditures in terms of operating expense, or it's coming from, like, higher gross margin because the revenue mix change? Thank you very much.

Fu Sheng: (Speaking in Chinese)

Vincent Jiang: Okay, let me translate.

As translated: So this is a very good question. At this stage we do not disclose a lot about the portion of revenue contribution from the in-game purchase. And it is at this stage that this portion is relatively lower. But on the other hand, it also means that there's a huge potential for our casual games revenues. As you know that the popular game Honor of Kings has certain social features there. And we have a very good [medium] purchase features that has demonstrated the great potential of our games.

And so, for us, we will publish or release a new game with more in-game purchase features. And we expect -- well, we will continue to add more social features to our casual games and add more in-game features, so that we hope that we can drive more revenue growth from the casual games.

Vincent Jiang: Okay, now let me take the second question about the profitability of the utility products. Well, I think, Joyce, you have asked -- you have made a true point that actually answered the question already. First of all, the improving profitability comes from the optimization of our cost and expenses. And also we optimized our product structure. Certain not so profitable products, we have some adjustment to that.

And the second part is that we do have very good growth from our mobile utility products in the domestic market. And that also contributes significantly to the revenue growth -- excuse me, to the profit growth. Thank you.

Joyce Ju: (Inaudible) much.

Operator: Is there a follow-up?

Helen Jing Zhu: Operator, can we go to the next question, please?

Operator: Thank you. The next question comes from Wendy Huang of Macquarie.

Wendy Huang: (Inaudible) --

Helen Jing Zhu: Wendy. Excuse me, Wendy.

Vincent Jiang: Excuse me, Wendy. Your voice kind of break up.

Wendy Huang: (Inaudible)?

Vincent Jiang: Yes, your voice kind of break up. Can you repeat the question, please?

Wendy Huang: Yes. First, can you give us some color on your partnership with Toutiao? How should we see the impact of this on your 2018 top line?

Fu Sheng: (Speaking in Chinese)

Vincent Jiang: Okay, let me translate.

As translated: So the purpose of our News Republic business is trying to monetize our user traffic from our utility products and services. By forming the strategic alliance with Toutiao, we can indirectly achieve this purpose, because our utility products can still be providing content from Toutiao's platform. And that will help the users of our utility products to increase their engagement and the time spent on our products, which of course will help the monetization of this user traffic.

Where we do have a revenue-sharing program -- excuse me -- we will have a revenue-sharing plan with Toutiao, but by doing this we will be able to reduce the costs for R&D expenses and also we'll reduce some other expenses related to band width and IDC centers and something like that.

So overall we expect that our revenue will increase and the profitability will be improved as well. Okay.

Helen Jing Zhu: Thank you. Can we move to the next question, please, Operator?

Operator: The next question comes from Robert Cowell of 86Research.

Robert Cowell: Thanks. My question is about the [invest in] Beijing Orion, and specifically the Xiao Ya speaker device. So I'm interested in what the market reception has been there.

And, more generally, on Beijing Orion, what is its competitive position or competitive advantage going up against other smart speaker devices or other language-based operating systems? I can try and translate briefly.

(Speaks in Chinese)

Fu Sheng: (Speaking in Chinese)

As translated: Okay, Robert. So for the first part of the question about the (inaudible) Xiao Ya speaker, well that speaker has been well received by the market and has a very good reputation among its users. And in terms of the time spent per user, unfortunately we cannot comment on that because that product is our partner, a business partner's product.

For the second question regarding the competitive advantage of Orion Star, because we think that the AI technologies has lowered the entry barrier for this kind of applications. And as you know, that the Xiao Ya speaker and the related AI technologies do have good reputations. Although the big companies, such as Baidu and Alibaba, has the potential to have more technology investments. But for us we have a better understanding of the products and all the different users (inaudible) to different usage scenario, because we have been developing products for all the years. And we are very experienced in product design and launch by ourselves. Okay.

Fu Sheng: (Speaking in Chinese)\

As translated: Oh, well, we are being modest. Have been a very good product manager for all these years. Yes.

Helen Jing Zhu: Thank you, Operator. Can we move to the next question, please?

Operator: (Operator Instructions) This concludes our question-and-answer session. I would like to turn the conference back over to management for any closing remarks.

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

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