

RLX Technology Inc.
Q3 2021 Earnings Conference Call
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Executives

Kate Wang, Co-founder, Chairperson of Board of Directors, Chief Executive Officer
Chao Lu, Chief Financial Officer
Sam Tsang, Head of Investor Relations

Analysts

Lydia Ling, Citigroup
Charlie Chen, China Renaissance
Louise Li, Bank of America Securities
Peihang Lv, CICC

Presentation

Operator: Hello, ladies and gentlemen. Thank you for standing by for RLX Technology Inc.'s third quarter 2021 earnings conference call. At this time, all participants are in listen-only mode. After management's remarks, there will be a question-and-answer session. Today's conference call is being recorded and is expected to last for about 45 minutes.

I will now turn the call over to your host, Mr. Sam Tsang, Head of Investor Relations of the Company. Please go ahead, Sam.

Sam Tsang: Thank you very much. Hello, everyone, and welcome to RLX Technology's third quarter 2021 earnings conference call. The Company's financial and operational results were released through PR Newswire services earlier today and have been made available online. You can also view the earnings press release by visiting the IR section of our website at ir.relxtech.com.

Participants on today's call will include our Co-founder, Chairperson of the Board of Directors and Chief Executive Officer, Ms. Kate Wang; Chief Financial Officer, Mr. Chao Lu; and myself, Sam Tsang, Head of Investor Relations.

Before we continue, please note that today's discussions will contain forward-looking statements made under the Safe Harbor provisions of the U.S. Private Securities Litigation Reform Act of 1995. These statements typically contain words such as "may," "will," "expect," "target," "estimate," "intend," "believe," "potential," "continue," or other similar expressions.

Forward-looking statements involve inherent risks and uncertainties. The accuracy of these statements may be impacted by a number of business risks and uncertainties that could cause actual results to differ materially from those projected or anticipated, many of which factors are beyond our control. The Company, its affiliates, advisors, representatives, and underwriters do not

undertake any obligations to update this forward-looking information, except as required under the applicable law.

Please note that RLX Technology's earnings press release and this conference call include discussions of unaudited GAAP financial measures, as well as unaudited non-GAAP financial measures. RLX Technology's press release contains a reconciliation of the unaudited non-GAAP measures to the unaudited GAAP measures.

I will now turn the call over to Ms. Kate Wang. Please go ahead.

Kate Wang: Thank you, Sam. And thanks, everyone, for making time to join our conference call today. Since the second half of the third quarter, there have been progressive regulatory developments throughout the global e-vapor space, including in China. Last Friday, November 26, 2021, the State Council announced its decision to amend the “Detailed Implementation Regulations of the Tobacco Monopoly Law of the People's Republic of China” by adding Rule 65, which states that “Implementation rules for next generation tobacco products, including e-cigarettes, shall refer to the relevant rules with respect to cigarettes under the Implementation Regulation of the Tobacco Monopoly Law.”

On Tuesday, November 30, 2021, the State Tobacco Monopoly Administration released a consultation paper entitled “Electronic Cigarette” on national public service platform for standards information under the State Administration for Market Regulation, seeking public comment regarding national electronic cigarette product standards.

Yesterday, December 2, 2021, the State Tobacco Monopoly Administration released a consultation paper entitled “Administrative Measures for Electronic Cigarettes”, seeking public comment regarding administrative measures on electronic cigarettes, covering various aspects including production, distribution, and retail sales, import and export, and inspections.

We firmly support this amendment to the Detailed Implementation Regulations, and have begun making any required changes to fully comply with the new regulations and administrative measures. We believe the amendment will pave the way for long-term and sustainable growth in this sector.

We are also aware of meaningful worldwide regulatory developments, which reflects similar trends globally. In the United States, the FDA has made substantial progress reviewing PMTA applications, and granted its first e-vapor product authorization in October, demonstrating its recognition of certain e-vapor products’ harm reduction effects. We closely follow global regulatory developments and view the legalization of e-vapor products as a global trend that will grow as countries worldwide recognize e-vapor products’ harm-reduction benefits for adult smokers.

With these regulatory developments, especially in China, we believe the sector will enter a new era of development, an era marked by enhanced product safety and quality, augmented social responsibilities, and improved intellectual property protection.

As some of you may be aware, the third quarter was challenging on the commercial front for the entire industry value chain, which had been reflected in our key value chain partners' financial results previously. Misinformation from temporary negative publicity on the e-vapor sector, and evolving COVID-19 restrictions in response to outbreaks in China, which we discussed during last quarter's earnings call, has had a significant adverse impact on the retail sales and product procurement by our branded stores since the latter half of the second quarter.

As a result, we recorded a 34% quarter-over-quarter decline in our net revenue. But we believe this revenue decline to be temporary and have a clear plan to achieve long-term, healthy growth, which Chao will explain in detail later.

Despite those industry headwinds, we continued to focus on building a solid foundation for sustainable success. In the third quarter, we redoubled our scientific research efforts and continued to attract and recruit top talent to strengthen our sales, supply chain, and R&D capabilities. We are committed to providing adult smokers with innovative harm reduction products of the highest quality.

Also at RLX, we also plan and act for the long term. Corporate social responsibility has been an integral part of our values since day one. In the third quarter, we unveiled our 2020 to 2021 corporate social responsibility report, wherein we shared our progress with respect to our CSR initiatives. Some highlights include our industry-leading age verification system, "Sunflower system 3.0," with enhanced features to prevent underage usage; our "RELX Care" community service program to promote rural revitalization and common prosperity. These accomplishments are a testament to our dedication to fulfilling our social responsibilities. We strive to positively impact our users, employees, and the communities in which we live.

With that, I will now turn the call over to our CFO Chao Lu. He will elaborate further on some of our last quarter's initiatives and go over our operational and financial results in more detail.

Chao, please go ahead.

Chao Lu: Thank you, Kate, and hello, everyone. I will start by sharing some of this quarter's major initiatives and developments, and then walk you through our key financial metrics.

We believe that offering the right products to the right user segments through the optimal route-to-market will be the key to our sustainable, high-quality growth. To this end, we continued to expand our product offerings to meet the needs of diverse user segments and optimize our distribution and retail networks to ensure quality growth.

With respect to products, we are focused on offering better and more tailored vaping products for various user groups to help engage new users with the right products. This quarter, we introduced "Yixiyun", a new brand targeting adult smokers with a long history of smoking. Our goal is to recreate an authentic smoking experience for adult smokers by launching 8 tobacco-flavored cartridges in our initial stage.

At the same time, we further upgraded “Qingfeng”, a more accessible product line catering to price-sensitive users' needs. We also recently launched “Stella”, or “Xinghe” in Chinese, a premium device line with upscale styling including leather, lace, and other fashionable materials. We will continue to monitor user experiences very closely and launch innovative, targeted products at the right time.

We also made several advancements in user retention and engagement during the quarter. We successfully upgraded our membership system, enabling members to enjoy more benefits as they accumulate reward points. A growing number of users are scanning the QR codes on their cartridges to collect reward points, which will allow us to empower users with instant product authentication. Separately, we have established more effective communication channels to provide unbiased, fact-based scientific e-vapor product information to our users and the community.

Finally, we are concentrating on distribution and retail channel optimization. Instead of engaging more distributors and expanding the number of our RELX-branded stores, this quarter we prioritized our existing distributors' organizational upgrade. We encouraged our distributors to hire exceptional talent and refine their team structure within each department. We optimized existing RELX-branded partner stores' locations by identifying areas with high retail sales potential and encouraging store owners to adjust their operations accordingly.

In addition, we provided online and offline trainings for store owners and sales personnel to enhance their communication skills and enrich their product knowledge, in order to counter the adverse effect from misinformation resulting from periodical negative publicity on our category.

We have also upgraded our digitalization system for branded partner stores, providing improved functionality and additional user portals to assist store owners and sales personnel in their daily operations. For our other retail outlets, our focus in the third quarter was to identify prime outlets for expansion through trials in various channels. These trials resulted in several initial successes, including strong momentum in lifestyle channels and other key accounts.

In addition to our emphasis on high-quality growth, we are deeply committed to fulfilling our corporate social responsibilities. We believe the healthy relationship between our products, users, shareholders, and the community has been essential to the growth we have achieved over RLX's 4-year history. With this in mind, we work tirelessly to introduce new technologies to tackle industry pain points.

For example, minor protection is one of RLX's highest priorities. We spare no efforts in our minor protection initiatives, from product labels to trade channels and technology innovation. In June 2021, we began upgrading “Sunflower System,” our technology-driven minor protection system, to version 3.0, and currently equipped all of our branded stores with the upgraded software. Under “Sunflower System 3.0,” all users are required to complete name + ID number + face recognition, 3-step verification before purchasing.

After the amendments to China's national standards become effective, we will strictly comply with any upgraded product requirements. For example, we are prepared to include minor protection features such as child safety locks, similar to the feature which we have incorporated into our

“RELX i” product line back in 2019. As a company that values long-term, high-quality growth, our commitment to corporate social responsibility is at the core of our daily operations.

To echo what Kate has pointed out previously, our game has entered the second half, with the State Council’s decision to amend the “Detailed Implementation Regulations of the Tobacco Monopoly Law” and the subsequent release of a consultation paper regarding national electronic cigarette product standards by the State Tobacco Monopoly Administration, as well as last night’s release of a consultation paper regarding administrative measures on electronic cigarettes, covering various aspects including production, distribution and retail sales, import and export, and inspections.

Different from the first half when the sector lacked clear regulatory guidelines, this second half is marked by enhanced product safety and quality, augmented social responsibilities, and improved intellectual property protection. The investments we made in products, talents, research, and compliance in the third quarter and beyond will place us in advantageous positions under the new regulatory paradigm. We expect these investments to yield steady and sustainable growth soon, and to reward us and our shareholders in the long run.

Turning to our financial results for the third quarter of 2021, net revenues decreased by 34.0% to RMB1.68 billion, equivalent to US\$260.2 million, in the third quarter of 2021 from RMB2.54 billion in the second quarter of 2021. The decrease was a result of volatile market conditions, including, (i) negative e-vapor industry publicity since the latter half of the second quarter; (ii) the fact that the draft new rules announced on March 22, 2021 had not been formally confirmed and no new implementation details had been revealed, during the quarter; and (iii) evolving restrictions in response to COVID-19 outbreaks in China, which had adverse impact on our sales and channel inventory management.

Gross profit decreased by 42.8% to RMB656 million, equivalent to US\$101.8 million in the third quarter of 2021, from RMB1.15 billion in the second quarter of 2021.

Gross margin was 39.1% in the third quarter of 2021, compared to 45.1% in the second quarter of 2021. The decrease was primarily due to, (i) an increase in direct costs related to promotional activities, and (ii) an increase in inventory provision.

Operating expenses were positive RMB241.3 million, equivalent to US\$37.5 million, in the third quarter of 2021, representing a decrease of 244.4% from RMB167.2 million in the second quarter of 2021. This significant decrease in operating expenses was primarily due to the recognition of share-based compensation expenses of positive RMB523.7 million, equivalent to US\$81.3 million, consisting of, (i) share-based compensation expenses of positive RMB90.8 million, equivalent to US\$14.1 million, recognized in selling expenses; (ii) share-based compensation expenses of positive RMB320.1 million, equivalent to US\$49.7 million, recognized in general and administrative expenses; and (iii) share-based compensation expenses of positive RMB112.8 million, equivalent to US\$17.5 million recognized in research and development expenses.

The significant fluctuations in share-based compensation expenses were primarily due to the changes in the fair value of the share incentive awards that the Company granted to its employees as affected by significant fluctuations of the Company's share price.

Selling expenses decreased by 55.1% to RMB56.5 million, equivalent to US\$8.8 million, in the third quarter of 2021 from RMB126 million in the second quarter of 2021. The decrease was primarily driven by, (i) the fluctuation of share-based compensation expenses, and (ii) a decrease in salaries and welfare benefits, partially offset by an increase in branding material expenses.

General and administrative expenses decreased by 649.8% to positive RMB253.2 million, equivalent to US\$39.3 million, in the third quarter of 2021 from RMB46.1 million in the second quarter of 2021. The decrease was primarily driven by the fluctuation of share-based compensation expenses and a decrease in salaries and welfare benefits.

Research and development expenses decreased by 808.3% to positive RMB44.6 million, equivalent to US\$6.9 million, in the third quarter of 2021 from positive RMB4.9 million in the second quarter of 2021. The decrease was mainly driven by the fluctuation of the share-based compensation expenses, and a decrease in salaries and welfare benefits, partially offset by (i) an increase in software and technical expenses, and (ii) an increase in consulting expenses.

Income from operations was RMB897.3 million, equivalent to US\$139.3 million, in the third quarter of 2021, compared with RMB979.3 million in the second quarter of 2021.

Income tax expense was RMB121.4 million, equivalent to US\$18.8 million, in the third quarter of 2021, compared with RMB204.2 million in the second quarter of 2021. The decrease was primarily due to a decrease in taxable income.

U.S. GAAP net income was RMB976.4 million, equivalent to US\$151.5 million, in the third quarter of 2021, compared to RMB824.3 million in the second quarter of 2021.

Non-GAAP net income was RMB452.7 million, equivalent to US\$70.3 million, in the third quarter of 2021, representing a decrease of 30.5% from RMB651.8 million in the second quarter of 2021.

U.S. GAAP basic and diluted net income per ADS were RMB0.724, equivalent to US\$0.112, and RMB0.717, equivalent to US\$0.111, respectively, in the third quarter of 2021, compared to U.S. GAAP basic and diluted net income per ADS of RMB0.595 and RMB0.591, respectively, in the second quarter of 2021.

Non-GAAP basic and diluted net income per ADS were RMB0.334, equivalent to US\$0.052, and RMB0.332, equivalent to US\$0.051, respectively, in the third quarter of 2021, compared to non-GAAP basic and diluted net income per ADS of RMB0.470 and RMB0.467, respectively, in the second quarter of 2021.

As of September 30, 2021, the Company had cash and cash equivalents, restricted cash, short-term bank deposits, short-term investments, and long-term bank deposits of RMB14.72 billion, equivalent US\$2.28 billion, compared to RMB14.88 billion as of June 30, 2021. As of September

30, 2021, approximately US\$1.64 billion, equivalent to RMB10.59 billion, was denominated in U.S. dollars.

For the third quarter ended September 30, 2021, net cash used in operating activities was RMB142.9 million, equivalent to US\$22.2 million.

This concludes our prepared remarks today. We will now open the call to questions. Operator, please go ahead.

Questions and Answers

Operator: Thank you. We will now begin the Question-and-Answer session. (Operator Instructions). Lydia Ling at Citi.

Lydia Ling: This is Lydia from Citi. I have two questions. My first question is given the recent regulation update developments, so would you like to share with us how will your product portfolio involve going forward? And what changes can we expect to see in your existing product portfolio?

And my second question is so we saw the further slowdown in the third quarter. So could you actually share more color on your fourth quarter to date operations trend, and also your outlook for next year, given the current regulation update and also the COVID situation?

Sam Tsang: Thanks very much, Lydia. Regarding your first question regarding our product portfolio, so we do have a very clear product development strategy. As mentioned in the opening remarks, we try to offer the right products to the right user segments through the optimal route-to-market channel.

We do aware of the press conference held by the State Tobacco Monopoly Administration yesterday, and also the announced product consultation of the “National Electronic Cigarettes and Product Standards”. Within the transition period of our new requirements to become effective, we will strictly comply with the regulatory guidelines.

Regarding what would be the change to our current product offerings, if and or when the draft “National Electronic Cigarettes Product Standards” become effective, we anticipate we may need to modify some of our current offerings. However, we are very confident that such changes won't be complex for our company technically. And we believe adult smokers will still continue to seek out and use our products as harm-reduction alternatives.

Regarding your second question about our 4Q outlook in 2020, so we currently do not have any guidance for the quarter together with next year. We hope to share more when we have better clarity.

Operator: Charlie Chen at China Renaissance.

Charlie Chen: I have two questions here. The first one is could you please share your observations on the current competitive landscape for this industry? Are there any changes compared to the first half of this year? And also, what are your thoughts on the retail pricing for the industry in the current environment? So that's the first question.

And my second question is regarding single-store sales. So what are the single-store sales of RELX-branded partner stores for now? From your perspective, where do you consider to be a healthy single-store sales level?

Sam Tsang: Thanks very much, Charlie. So there are two questions. One is on the competitive landscape and the other one is on our RELX-branded partner stores.

For the first one, as mentioned before, during the latter half of the second quarter, we do see that the industry development did not progress as expected. Indeed, this has carried into the third quarter, and we do see that there are external factors affecting the entire industry, including our company and also our peers, to varying degrees. But indeed, regarding competitive landscape, we have observed reduced industry competition as compared to the first half of 2021.

For retail price that you have mentioned, we have increased our promotional efforts in the third quarter, trying to drive our retail sales and reduce inventory pressure of our value chain. And we have also seen that given the third quarter decline in general consumer spending in China, many other companies similarly implemented subsidies or other sales incentives. For the overall magnitude, our subsidies or promotional efforts is relatively insignificant compared to other consumer goods company in China, and we have already started reducing this further.

Going forward, we will continue to monitor our inventory level, together with user demand, and adjust our promotional efforts promptly to maintain a reasonable retail price for our end users.

Regarding your second question about the single-store sales and also how we measure healthy as the indicator, so indeed, single-store sales, together with their profitability and every operating metrics, has really been a core focus in our day-to-day operations. We are also aware of the industry-wide dip in retail sales starting in the second half of 2021. But however, we also see there has been a recovery for many of our stores in recent months.

As our stores operate in a wide variety of locations, some of them are in shopping malls and some of them are on the streets, and they also face different local environments, we believe each store situation is very unique. Indeed, we currently do not have a “healthy parameter” for single-store sales as we look at it one-by-one.

As a branded e-vapor company, we have been devoting resources and tools to assist store owners and sales personnel in their daily operations, including providing branded materials, POSM, training resources, digitalization tools, and enhanced store site selection assistance.

For this quarter, we have also launched several new products and also upgraded our membership system to drive user engagement and retention better. With these initiatives, we believe we can, and we will, continue to drive single-store sales of RELX-branded partner stores. Thank you very much.

Charlie Chen: Thank you.

Operator: Louise Li at Bank of America.

Louise Li: So my question is also for the Q4 outlook. I understand that you don't have the guidance, but you just mentioned that you have seen some recovery during the past months. So could you please share with us more color on the recovery in terms of the single-store sales? And what is the store count actually now? And what is our target for the year-end? And also, what is the key growth driver for the recovery?

Sam Tsang: Thanks very much, Louise. So based on our preliminary quarter-to-date data, we do see sequential improvements in retail sales and also channel inventory management. We could share more about our strategies in the following aspects.

For RELX branded-partner stores for quarter to date, we have been focusing on increasing single-store sales through our initiatives being mentioned. And up till now we do see that initial success. For other retail outlets, we do see strong growth momentum in store counts in multiple channels, and our retail channel has become more diversified from quarter-to-date.

But of course, we are also keenly aware of the recent developments in the regulatory events, especially yesterday's press release held by the State Tobacco Monopoly Administration. We will carefully follow to any new regulations and administrative measures. Thank you very much.

Operator: Peihang Lv with CICC.

Peihang Lv: I am Peihang Lv at CICC. I have one question is that what is the outlook for purchase development under the nicotine limit of 2%?

Sam Tsang: Thanks very much, Peihang. So, I believe you are actually referring to the Tuesday draft electronic cigarette product standards. So indeed, as a U.S.-listed Chinese company, we have been long been aware of product requirements globally, including in the European Union and also initial draft of national product standard. Looking at the well-developed markets penetration, we believe lowering nicotine concentration will affect some user segments' satisfaction, however, most of the adult smokers could still satisfy with such nicotine content or limits in the long run.

From the perspective of product development or technology development, we have kicked off projects related to "low nicotine concentration, better satisfaction" since 2019. We do have the technical know-how and product reserves. Currently, as you may know, most of our cartridges' nicotine concentration is 3%. If such national standards become effective, we'll strictly comply with other requirements listed on the national product standards, including on nicotine content. Thank you very much.

Operator: Thank you. And ladies and gentlemen, this concludes the question-and-answer session. I'd like to turn the conference back over to the company for final remarks.

Sam Tsang: Thank you once again for joining us today. If you have further questions, please feel free to contact RLX Technology's Investor Relations team through the contact information provided on our website or TPG Investor Relations.

Operator: Thank you. Ladies and gentlemen, this concludes today's conference call. You may now disconnect your lines, and have a wonderful day.