

RLX Technology Inc.
Q1 2022 Earnings Conference Call
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Executives

Sam Tsang, Head of Investor Relations

Chao Lu, Chief Financial Officer

Analysts

Lydia Ling, Citi

Charlie Chen, China Renaissance

Peihang Lv, CICC

Presentation

Operator: Hello, ladies and gentlemen. Thank you for standing by for RLX Technology Inc.'s First Quarter 2022 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 40 minutes.

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

Sam Tsang: Thank you very much. Hello, everyone, and welcome to RLX Technology's first quarter 2022 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 CFO, Mr. Chao Lu, and myself, Sam Tsang, Head of Investor Relations.

Before we continue, please note that today's discussion 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, and representatives do not undertake any obligation 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 will include discussions of unaudited GAAP financial measures, as well as unaudited non-GAAP financial measures. RLX'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 Mr. Chao Lu. Please go ahead.

Chao Lu: Thank you, Sam, and thanks everyone, for making time to join our conference call today. As you are probably aware, the e-vapor industry is currently being reshaped by a mix of regulatory developments and solid demand for high-quality, safe products, both of which are influencing our short-and-medium-term strategy and outlook. While these developments are significant, we remain confident in our strategy and committed to building and enhancing the trustworthiness of our brand.

As always, we will maintain strict compliance with the applicable regulatory requirements and uphold our core values, while providing premium-quality products and creating user satisfaction with our industry-leading technologies, scientific advancements and adaptable approach.

To give you a general sense of what is happening in China's e-vapor industry, I'd like to provide a macro view of what we are seeing and how our business is serving our users and society as we adapt to the industry's transformation. Following the publication of the final Administrative Measures for E-Cigarettes in March, the national standards and a set of detailed regulatory measures on e-cigarettes licensing, logistics, etc., were released in the past few weeks.

We fully embrace these new regulations, including the administrative measures and relevant implementation guidelines, as they further refine the regulatory framework with clear standards and boundaries. This will benefit those existing industry players who, like RLX, are capable of adapting to the new infrastructure while maintaining their scale, as well as their ability to manage user experiences and risks effectively and efficiently.

We have included a brief summary of the recent regulatory developments in our earnings release and more detailed analysis in our annual report on Form 20-F.

Now, let me walk you through some of the key developments. First, as you might have noted, the final National Standards will come into effect on October 1, 2022, granting a transition period until September 30, 2022. This provides industry players like us additional time to better adapt to the new regulatory regime and minimize disruptions for our users and the e-vapor market.

In addition, we noticed that a regulatory pilot program was launched in April in Huizhou, Guangdong province and Xiamen, Fujian province. Under this pilot program, the new administrative measures were implemented early in these two cities to assess the new e-vapor product supervision process. In accordance with the new policy, selected local retailers began placing orders for e-vapor products with the local subsidiaries of China Tobacco that will

distribute e-vapor products in local districts going forward, to ensure that the process is running smoothly before the new mechanism is rolled out nationwide.

Also, the National Standards tighten the R&D and quality control standards for e-vapor products in China, advocating product safety and limiting opportunities for counterfeit and unauthorized compatible products.

Next, I want to highlight our proactive actions in response to these regulatory changes. Regarding the licensing requirements under the administrative measures, we have already initiated manufacturing license applications. As the leading industry player, we believe we satisfy the relevant application requirements.

In alignment with the requirements stipulated in the final National Standards, we have already developed e-vapor cartridges and devices that we believe are in compliance with the National Standards, and submitted them to the State Tobacco Monopoly Administration for technical review. We believe that our products will pass the review and be successfully launched to market in due course.

I'd also like to mention a user event that we hosted in April at the RELX lab in Shenzhen. A dozen of our existing users were invited to sample our new products and observe presentations by our technologists showcasing our in-depth knowledge and technological advancements throughout our product R&D process, as well as on-site experiments. The feedback we received from this event, together with the results of our user survey, encouraged us to forge ahead with the user-centric product strategy we designed to adapt to the regulatory changes.

Given that our adaptation initiatives to enhance user experience and satisfaction are supported by our product development capabilities, industry-leading technologies and scientific advancements, we are confident that our new products will be well-received by most of our existing users.

To smooth our transition to the new operational regime, we are optimizing our operational structure in many aspects, such as warehousing and logistics, ERP system, etc.

Last but not least, we are aware that as of now, in response to the changes in the industry value chain, several provinces and cities have locally announced that they will issue more than 48,000 retailers' licenses in total in the initial stage of regulatory implementation. We believe that this number will be adequate to satisfy most of the industry's existing stores' needs.

Given our relentless efforts to strengthen our operational capabilities and provide superior products to our users, we are optimistic about our ability to capture the market potential ahead of us under the new regulatory landscape. As a trusted e-vapor brand for adult smokers, we will continue to strictly comply with the new regulations and policies, while deepening our commitment to providing high-quality products and exploring new growth opportunities in the industry.

Before moving on to discuss our financial performance, I would like to highlight that in the dynamic market in which we operate, our dedication to upholding our long-term commitments

and fulfilling our responsibilities to our industry, environment and society is at the core of our ongoing success. Since our inception, we have worked to advance a wide range of ESG initiatives within the stakeholder communities we serve. Our 2021 ESG report showcases our actions and progress, including our low-carbon development strategies and climate-related information disclosures.

Most recently, we have set targets to achieve carbon neutrality across Scope 1 and Scope 2 by 2033, and accomplish net zero for Scope 3 no later than 2050 through eight key initiatives. We are unwaveringly committed to strengthening our ESG governance and management system, creating and meeting long-term ESG goals to ultimately empower our sustainable development.

Now, I'd like to share some key updates regarding our first quarter financials. Our top -line performance in the first quarter continues to demonstrate the resilience of our business and our ability to navigate the rapidly changing market amid the challenges stemming from the COVID-19 related restrictions and the evolving regulatory environment. Since early March, we have seen a strong recovery in demand from distributors, as the release of the administrative measures brought near-term clarity for e-vapor operations.

However, our shipment volume in the quarter was adversely impacted by the production stoppage at our exclusive production plant and delays by some of our suppliers in Shenzhen, as the city imposed a lockdown during that period, in addition to the seasonal impact of the week-long Chinese New Year holiday.

Our GAAP gross margin, however, declined year-over-year. This was primarily attributable to the shift in our revenue mix due to the increasing proportion of cartridge sales compared with the same period last year. Thanks to our continued efforts to optimize our supply chain and streamline our operations, we maintained a steady unit cost in the first quarter. Excluding one-off costs related to inventory provisions from the GAAP gross margin, we sustained our gross margin at a level similar to that in the fourth quarter of 2021.

Facing macroeconomic uncertainties, tightening COVID-19 restrictions and the evolving regulatory environment, we remain diligent in controlling our costs and further improving our operational efficiency through an array of initiatives designed to further streamline operations.

As the saying goes, uncertainty is the only certainty. Our balance sheet remains strong with a cash position of approximately RMB14.9 billion as of March 31, 2022.

Also, we have generated positive operating cash flows in each of the past three years. We believe our strong cash position and robust cash flows build a firm foundation for us to better adapt to the new regulatory environment and market dynamics. Also, during these times of uncertainty, our strong capital and liquidity position is an important source of confidence for all our stakeholders.

I will now provide a summary overview of our financial results for the first quarter of 2022.

Net revenues were RMB1.7 billion in the first quarter of 2022, compared with RMB2.4 billion in the same period of 2021. The decrease was primarily due to the impact of COVID-19 on our production plant in Shenzhen, which adversely affected our production and shipment volume.

Gross profit was RMB657 million in the first quarter of 2022, compared with RMB1.1 billion in the same period of 2021.

Gross margin was 38.3% in the first quarter of 2022, compared with 46% in the same period of 2021. The decrease was primarily due to, first, a change in product mix, and second, an increase in inventory provision largely due to recent regulatory developments.

Operating expenses were RMB33.6 million in the first quarter of 2022, representing a decrease of 97.2% from RMB1.2 billion in the same period of 2021. The decrease in operating expenses was primarily due to the change in share-based compensation expenses, which decreased to a positive RMB325.2 million in the first quarter of 2022 from RMB877.5 million in the same period of 2021, consisting of (i) share-based compensation expenses of positive RMB41.9 million recognized in selling expenses; (ii) share-based compensation expenses of positive RMB230.1 million recognized in general and administrative expenses; and (iii) share-based compensation expenses of positive RMB53.2 million recognized in research and development expenses.

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

Selling expenses decreased by 73.9% to RMB75.9 million in the first quarter of 2022 from RMB291.5 million in the same period of 2021. The decrease was primarily driven by (i) a decrease in share-based compensation expenses; (ii) a decrease in salaries and welfare benefits; and third, a decrease in branding material expenses.

General and administrative expenses decreased by 109.3% to a positive RMB66.4 million in the first quarter of 2022 from RMB712.8 million in the same period of 2021. The decrease was mainly driven by (i) a decrease in share-based compensation expenses, and (ii) a decrease in salaries and welfare benefits, partially offset by an increase in legal and other consulting expenses.

Research and development expenses decreased by 88.7% to RMB24 million in the first quarter of 2022 from RMB211.6 million in the same period of 2021. The decrease was primarily driven by (i) a decrease in share-based compensation expenses; (ii) a decrease in salaries and welfare benefits, partially offset by (i) an increase in depreciation and amortization expenses and (ii) an increase in software and technical service expenses.

Income from operations was RMB623.4 million in the first quarter of 2022, compared with a loss from operations of RMB111.9 million in the same period of 2021.

Income tax expense was RMB112.6 million in the first quarter of 2022, compared with RMB176.3 million in the same period of 2021.

U.S. GAAP net income was RMB687.1 million in the first quarter of 2022, compared with U.S. GAAP net loss of RMB267 million in the same period of 2021.

Non-GAAP net income was RMB361.8 million in the first quarter of 2022, compared with RMB610.5 million in the same period of 2021.

U.S. GAAP basic and diluted net income per ADS were RMB0.528 and RMB0.521, respectively, in the first quarter of 2022, compared with the U.S. GAAP basic and diluted net loss per ADS of RMB0.174 in the same period of 2021.

Non-GAAP basic and diluted net income per ADS were RMB0.284 and RMB0.281, respectively, in the first quarter of 2022, compared with RMB0.398 in the same period of 2021.

Moving to the balance sheet. As of March 31, 2022, the Company had cash and cash equivalents, restricted cash, short-term bank deposits, short-term investments, and long-term bank deposits, net of RMB14.9 billion, compared with RMB14.4 billion as of March 31, 2021. Among them, approximately US\$1.6 billion was denominated in U.S. dollars as of March 31, 2022.

Looking ahead, we will continue to focus on the business elements under our control, such as product innovation, cost optimization and operating efficiency to reinforce our fundamentals and position ourselves to seize future opportunities. We are confident in the future of our Company, together with our industry and therefore, we have been steadily implementing our share repurchase program, creating value for our shareholders and long-term investors.

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). For the benefit of all participants on today's call, if you wish to ask your question to management in Chinese, please immediately repeat your question in English.

Today's first question comes from Lydia Ling with Citi.

Lydia Ling: This is Lydia from Citi, and thanks for the presentation and update for the first quarter and on the regulation side. So I have two questions here. So the first question, so as you just mentioned, there are quite a few updates on the regulation side for first quarter. And we also see many provinces now have detailed out the retail management measures. So we are very keen

to have more color from you that in terms of your license application. For example, like what timeline you expect that you can get your production license? And also your expectation on what percentage of your retailers make at the retail license? And we are also very interested to know that what could be the initial feedback from your new products? This will be very helpful to us.

And my second question is we also know that there will be the non-exclusive retail terms on your retail side. So how do management see the competitive landscape looking forward, as your retailers might tend to include more brands at store level in order to get a license?

Sam Tsang : Thanks very much, Lydia. So the first one is on the license application together with the product development to accommodate new opportunities. It's mainly on the exclusivity term that has been removed in the later regulations. So the first one is on the license. So we have already submitted our manufacturing license application to the State Tobacco Monopoly Administration. So now we are still waiting for the regulatory approval for obtaining such license, and we are confident that we would be the first batch of brand manufacturer to obtain such manufacturing license.

And regarding your question regarding the retail license, we believe that most of the retailers that operate the mono-brand store model of our industry to obtain a retail license during the transitional period. And regarding the new product development, we are still undergoing the final testing phase with both small and large user testing groups; fully strive to excel in the taste of our newly tobacco flavored cartridges, which fully comply with the national standards, while at the same time, also ensuring our product safety.

And for your the second question is mainly on the exclusivity term of the retailers. So based on our observation, we do not see that the competitive landscape has changed much recently, nor will it change significantly in the short-and-medium-term. We believe that what really makes a difference to a brand market share is NPS, i.e., Net Promoter Score, brand equity, user base and also the R&D capabilities. And these all are equally important, rather than the exclusivity. So during the transitional period from this month, we have seen the stats from retailers, who are previously on mono-brand stores in the industry, start selling other brands' products.

Indeed, we think that the non-exclusivity clause provide us with direct access to retailers who previously were other brands' partner stores. So before these retailers may not have sold our products, or only sold our products on an ad-hoc and informal basis. So with the clause being removed, they now chose to list our products, as we are the largest player in the market and our brand recognition can definitely help them to drive the single-store sales.

So on the other hand, for some retailers who are previously our exclusive brand partner stores, they also start listing other brands' products, as these brands might provide them with some free or promotional products. Now, however, based on our observation, these brands have not yielded significant retail sales, given their NPS brand equity user base and product capabilities are less robust than us.

So in summary, we believe that our market leadership is based on these key backers, rather than the exclusivity. And we can still maintain a relatively high market share going forward.

Lydia Ling: Thank you.

Operator: Charlie Chen at China Renaissance.

Charlie Chen: I have two questions as well. The first one is regarding the sales momentum in the second quarter of this year, as we know that effectively, all of your products are actually sold offline. So can you share with us some color on how these COVID-control measures could impact your sales and what's the sales momentum so far?

And my second question is regarding the status of your distribution channels. In particular, I would like to get some sense on whether there is kind of a distributor quitting this business, or they're leaving you because of the regulatory restrictions? And also, how about the retailers, for example, how's the sales or retailers and distributors in the pilot areas in Huizhou and Xiamen?

Sam Tsang: Thank you very much, Charlie. So regarding our second quarter sales, so as mentioned in our opening remarks, our net revenues in the first quarter were mainly being affected by the COVID restrictions in Shenzhen, which affected our production volume and also our shipment volume. So we have been better fulfilling our distributors' orders since the latter part of March. And our quarter-to-date performance has been robust and is in line with our expectation. So currently, we do see that there are some COVID restrictions in certain areas nationwide, for example, in Shanghai and Beijing. So these areas do not contribute material sales from a retail perspective.

And regarding your question about the pilot program and also how is the current distributors and retailers. So regarding the pilot program, the collaboration has been very smooth in both Xiamen and Huizhou, and we do see a very strong sales pace as well. So we believe that such pilot program could be a good indicator and could help the industry better adapt to the new regulatory regime.

And regarding the distribution channels, so our current distributors who are the private companies who still distribute the products during the transitional period. And given that the business performance has been robust and they could profit from making the transaction. So as of today, we have not seen any significant attrition of our existing distributors. Thank you for your question.

Charlie Chen: Thank you.

Operator: Peihang Lv with CICC.

Peihang Lv: This is Peihang at CICC. Actually, I have two questions to ask. And the first one is how is the company's inventory level and especially, how is the channel's inventory level? We also noticed that consumers were stocking cartridges recently. So from your opinion, how many cartridges are estimated to be stored by each user?

And my second question is that from the perspective of cost reduction, what actions have you taken so far, and how would you plan to do in the future?

Sam Tsang: Thanks, Peihang. So the first one is on the inventory level for each of our stakeholders and also us, and the second one is mainly on the cost optimization measures. So for the first question, as you can review our balance sheet, our inventory has remained at a relatively low level, down from close to 600 million in the fourth quarter, to 267 million in the first quarter. And out of these amounts, only a small portion of that is finished goods. So in light of the effectiveness of the national standards, and also some of the slow-moving SKUs, we have been very prudent and have established adequate inventory provisions in the last two quarters.

So regarding our trade inventory, i.e., the inventory in our distribution channels, it has been significantly decreased throughout the first quarter due to the COVID-19 restrictions in our Shenzhen factory. And this situation has been gradually improved since the second quarter. But we have been cautiously distributing our products, as we don't want the channels to have too much inventory.

And finally is regarding our users' inventory. So based on our membership data, we are aware that the average cartridge purchase per user per month has decreased by a moderate level since December of last year. Given this currently, we are still in the transitional period through September 30, we will, by then, have better visibility regarding our users' estimated inventory turnover days of our existing product portfolio.

So your second question is on the cost optimization initiatives. So we strive to optimize our costs in many aspects from the unit cost of each BOM, and also the packaging and also the logistics and warehousing costs. So previously, we have been able to reduce our packaging and warehousing costs by changing our packaging design and increasing our warehousing utilization rates.

Regarding the unit cost of each BOM, we are consistently communicating with our suppliers. We have been driving down our procurement costs, thanks to the technological advancements and automation of our supply chain. So going forward, we will still optimize our cost in these aspects from a unit cost of each BOM to our product design, as well as our continuous improvement in the utilization of supply chain process. Thank you for your question.

Peihang Lv: It's very clear and comprehensive. Thank you.

Operator: Ladies and gentlemen, this concludes our question-and-answer session. I would like to turn the conference back over to the company for closing 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 for the contact information provided on our website or TPG Investor Relations. Thank you.

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