RLX Technology Inc.
Q2 2022 Earnings Conference Call
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Executives
Kate Wang, Chief Executive Officer
Chao Lu, Chief Financial Officer
Sam Tsang, Head of Investor Relations

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 second 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 Inc.'s second 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 CEO, Ms. Kate Wang; our CFO Chao Lu, and myself, Sam Tsang.

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, and representatives 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'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 Kate. Please go ahead.

Kate Wang: Thank you, Sam. And thanks everyone, for making time to join our earnings conference call today. I'm pleased with the healthy financial performance we delivered in the second quarter as we proactively continued to adapt to the new regulatory framework. We remain focused on enhancing the full range of our capabilities, from scientific research, product development, to manufacturing advancement and operation optimization, all of which empower us to navigate the highly dynamic market and evolving regulatory landscape.

Amid strong macro headwinds and weak consumer sentiment, our solid second quarter results underscore the resilience of our defensive business model and our commitment to building and strengthening our brand's trustworthiness.

Before taking a closer look at business updates, I'd like to start with a brief recap of the milestone regulatory developments in our industry. Beginning in the first quarter of 2022, the relevant government authorities in China have issued a series of implementation rules and guiding opinions to strengthen oversight of e-cigarette products and regulate the e-cigarette industry, including the Administrative Measures for E-Cigarettes that came into effect in May and the new National Standards that will become effective on October 1, 2022.

Now, let me share our progress on our relevant license applications as required by the Administration Measures. To date, two of our subsidiaries have obtained the License for Manufacturing Enterprise from the State Tobacco Monopoly Administration, (STMA), to conduct manufacturing activities under the regulatory guidance. Specifically, one is approved to manufacture e-liquid, and the other is approved to own the RELX brand and manufacture RELX branded e-vapor rechargeable devices, cartridge products, and other relevant products.

Obtaining these licenses marked an important milestone in our strategic roadmap as we actively embrace the new paradigm with prompt regulatory compliance. We believe our solid fundamentals, industry-leading research and development capabilities, and seasoned team will assist further in our mission to achieve full regulatory compliance for our operations according to schedule.

To build on this progress, we have redoubled our efforts to develop new products that meet the applicable requirements while fulfilling users' demands. Some of our new products were among the first batch of products in the industry to obtain approvals under the new national standards, a powerful validation of our industry-leading R&D capabilities. We look forward to bringing the approved products to market very soon and are confident that our products' quality, performance and safety will continue to resonate well with our users.

Currently, we have several additional newly-developed products in the process of technical review and many more in the application pipeline. In the future, we will remain committed to fulfilling our users' demand for safe, high-quality products in strict compliance with regulations, while exploring new growth opportunities in the industry.

In particular, we firmly believe that R&D is the key to our success and sustainable future growth. It is R&D that has enabled us to quickly roll out compliant new products and maintain our brand's competitive edge. Here are a set of metrics tracking our R&D spending. Our non-GAAP R&D expense ratio has increased from 1.5% in 2018 to 3.6% in the first half of 2022, and is expected to further increase in the coming years.

Beyond product R&D, we are also dedicated to fundamental scientific research to protect our users' health, working relentlessly to better understand and minimize the health risks associated with e-vapor products. To that end, in addition to running our own scientific labs, we have partnered with various leading research institutions including ten universities, two hospitals, and several independent academic research houses, to conduct related research and development, building a firm foundation for ongoing product development and innovation.

Furthermore, in the second quarter, we collaborated with Shenzhen Institute of Advanced Technology Chinese Academy of Sciences on an e-vapor cooling agent inhalation study, which concluded that e-vapor products containing WS-23 have lower rewarding effects than pure nicotine products, a breakthrough we believe will support us to deliver a better, safer experience for adult smokers.

Turning now to our operations. Alongside our efforts to comply with applicable regulations, we continued to streamline our business structure and operational workflow during the second quarter to enhance our agility and flexibility. Our approach has yielded good initial results, with non-GAAP expense ratio decreasing quarter-over-quarter. Chao will elaborate on this further a bit later. We believe this comprehensive operational enhancement will enable us to nimbly tackle critical changes and swiftly adapt to the market evolution, boosting both our immediate and long-term efficiency.

In conclusion, we remain confident in the inherent potential of China's e-vapor market. We believe that as a trusted e-vapor brand for adult smokers, our leading technologies and scientific advancements, high-quality user base, resilient business model and strong overall execution are our fundamental assets that will empower us to drive sustainable quality growth in the long run and further strengthen our leadership position in the industry.

More importantly, we will continue to seek regulatory approvals to meet all applicable requirements on schedule while developing qualified products to deliver superior performance, further enhancing operational efficiency, and capturing the industry's growth opportunities ahead of us.

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 now provide a summary overview of our financial results for the second quarter of 2022.

In the context of a challenging macro environment and Covid resurgence, consumer sentiment slumped to a record low in the second quarter. According to the National Bureau of Statistics of China, the overall consumer confidence index fell from 121.5 in January 2022 to 88.9 in June 2022. Also, overall retail sales in China decreased by 0.7% year-over-year in the first half of 2022.

By actively adapting our business to the market and diligently improving our operational efficiency, we delivered solid and healthy results for the second quarter, recording net revenue of RMB2.2 billion. However, we believe this elevated level of revenue in the second quarter was primarily due to frontloading of sales in the downstream value chain in anticipation of the discontinuation of our older products as the industry transition period nears its end in the third quarter. Revenue decreased year-over-year; however, this was mainly due to the suspension of store expansions and new product launches during the regulatory transition period as we work to strictly comply with the relevant requirements.

Our gross profit was approximately RMB1 billion in the second quarter, with gross margin of 43.8% for the second quarter, compared with 45.1% in the same quarter of 2021. The decrease in gross margin was primarily due to an unfavorable product mix shift, an increase in inventory provision, and an impairment loss recognized for PP&E to comply with recent regulatory developments

Due to a significant increase in share-based compensation expenses to RMB193.2 million from a positive RMB172.5 million in the same quarter of last year, our operating expenses reached RMB530.9 million in the second quarter of 2022, compared with RMB167.2 million in the same period of last year.

Specifically, our selling expenses decreased by 2.7% to RMB122.6 million in the second quarter of 2022 from RMB126 million in the same period of 2021, mainly driven by a decrease in salaries, welfare benefits and branding material expenses, while partially offset by an increase in share-based compensation expenses.

General and administrative expenses increased to RMB290.7 million in the second quarter of 2022, from RMB46.1 million in the same quarter of 2021, mainly driven by the increases in share-based compensation [expenses], salaries, and welfare benefits.

As we remained focused on strengthening our R&D capabilities, our research and development expenses were RMB117.6 million in the second quarter of 2022, compared with a positive RMB4.9 million in the same period of 2021. This increase was mainly driven by increases in share-based compensation expenses, salaries and welfare benefits, and consulting expenses.

To echo what Kate mentioned about our business structure enhancement, our proactive cost optimization initiatives also continued to bear fruit this quarter.

If we exclude share-based compensation, our non-GAAP expense ratio decreased to 15.1% in the second quarter from 20.9% in the prior quarter. Notably, non-GAAP selling expense ratio decreased to 4.7% in the second quarter from 6.9% in the preceding quarter. If we exclude the impact of one-off items such as impairment loss, our adjusted expense ratio was similar to the level of the same period of last year. We believe the adjusted metrics may better reflect our efforts and achievements with respect to operational improvement during the quarter.

As a result, our non-GAAP net income increased to RMB634.7 million from RMB361.8 million in the prior quarter.

Non-GAAP basic and diluted net income per ADS were RMB0.494 and RMB0.492, respectively, in the second quarter of 2022.

Moving on to our balance sheet. We have a solid balance sheet. In particular, our cash position remains strong with cash and cash equivalents, restricted cash, short-term bank deposits, short-term investments, and long-term bank deposits, net of RMB16.8 billion as of the end of June 2022, compared with RMB14.9 billion a year ago.

In addition, we generated a positive operating cash flow of RMB1.4 billion, with an increase in the operating cash flow over non-GAAP net income ratio to 228% in the second quarter of 2022 from 100% in the same period of last year.

Our strong cash position and sufficient operating cash inflow enable us to agilely adjust our business when facing challenges and support our efforts to capture potential growth opportunities in the industry. In light of the regulatory changes, we are off to a slow but steady start of the sales of our new products that are compliant with the National Standards through the new transaction system mandated by the regulators.

In closing, we believe that e-vapor products will continue playing a vital part in harm reduction for adult smokers in the new regulatory era. With our products' superior quality and safety, our brand will continue to resonate well with adult smokers. Moving forward, we will focus on cost optimization while continuing to reinforce our product competitiveness to create sustainable, long-term growth for our shareholders.

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 from Citi.

Lydia Ling: This is Lydia from Citibank. I have three questions. And the first one is I actually saw some of the new products that you introduced in the select region. So we want to know what's the user feedback so far? , and so what's your thoughts on new flavors' impact on the sales volume in the following quarters? So this is the first question.

And the second question is actually we saw that the retailers now may have over three brands at the store level. So we want to know your view on the competitive landscape looking forward.

And the last question is actually we are now in September. So could you share with us the third quarter-to-date performance and also your outlook for the fourth quarter and 2023?

Sam Tsang : Thanks very much, Lydia. So the first question is mainly on the sales volume of the new products and the second one is mainly on how the competitive landscape goes; and the final one is on the outlook for the fourth quarter and so.

So regarding the first one is the impact after we launch our products that comply with the national standards. As we just launched these products a few weeks ago, so to be honest, I think the vast majority of our users haven't had a chance to try our products. Given that, we are still in the transition period, which will last till September 30. It's difficult for us to give a quantitative guidance regarding future quarters, given that there are some products are still being approved at the moment.

But when we look at the lessons and data learned from the flavor ban in the United States back in 2020, it took few quarters for users in the U.S. market to adapt to the new flavors and recover the industry volume. So there have been more and more products being approved in the past few weeks, which we believe could be launched very soon and could cater more to the users' needs. So we'll have a more clear picture of our user demand change in the late 4Q, after users digest their flavored inventories on hand.

And regarding the second question that there could be multiple brands selling in one single store going forward, so in our view, the ultimate goal for the retailers is to maximize their store productivity and their own profitability. Instead of selling only one brand in a single store, so retailers have to sell multiple brands under the new regime. We don't expect any material impacts on the competitive landscape, as retailers have always had the chance to select their designated brands collaborate.

So we believe the brand share of the store should be determined by product quality, brand equity and user base. And based on our observations, our brand share remains steady in the past few months. But in the future, we will continue to invest in strengthening our R&D capabilities. And our non-GAAP R&D expense has been steadily increasing in the past quarters, and we expect it to further increase in the coming quarters. With our increased efforts in R&D, we will continue to offer a better, safer experience for adult smokers.

So the last question is on the fourth quarter outlook. As prepared in our opening remarks, our second quarter revenue benefited from the frontloading of sales in the downstream value chain in anticipation of the discontinuation of our older products as the industry transition period neared its end in the third quarter. The resulting high base for comparison will impact our sequential third quarter results, and meanwhile, we gradually decreased our shipments of old products throughout the third quarter to better transit into the new regime, which will affect our third quarter number.

So given that the transition period will end on September 30, it will take more time for us to better project the future outlook especially for the fourth quarter. Thank you for your questions.

Lydia Ling: Thank you.

Operator: Charlie Chen from China Renaissance.

Charlie Chen: I've got two questions. The first one is regarding your product pipeline, especially the new products which should be -- and abide with the new regulations or new national standard. So what I want to ask is what is the status of your new product application? In particular, how many have been approved, how many now still pending? And also how many have been rejected, if there is any? And what is your product portfolio plan for the coming year for the next 12 months or so? So that's my first question.

And my second question is about the schedule of your product recycling or reshuffling. I remember last time, you said you planned to phase out your old products in the second quarter or third quarter. So I just want to know when exactly have you phased out or stopped producing old products, which not abide by the new national standards? And when is the time when you have new products started production or started to sell to the market? So that's my two questions.

Sam Tsang: Thanks, Charlie. So the first one is mainly on the product approvals, and the second one is on the old product phase-outs. So for the new regime, every new product must get approval before it launches, and the application itself will be an ongoing process. So we will continue diversifying our product portfolio under the new regime and offer quality products for adult smokers . As of today, we have received product approvals for low-teens of devices and low-teens of cartridge products. And some of our applications are still under review, and we expect the number of our approved products will keep growing.

And regarding the second one is about the old product phase-outs. We gradually slower our pace in production throughout the third quarter, with the vast majority of our production occurring in the first half of third quarter. So far, our sales of products that comply with national standards, we began to participate the testing of the transaction platform this month. We have been receiving more approvals in the past few weeks, and therefore, we are still in the early stage of rolling out the new products. Our current sales of these new products may not accurately reflect our users demand, as our users still have access to our old products, and these new products are just being approved very recently. So we will be able to provide more updates after the transition period. Thank you.

Charlie Chen: Thank you.

Operator: Peihang Lv from CICC.

Peihang Lv: This is Peihang at CICC. I have three questions actually. And the first one is could you please introduce a bit about the current entry level of your original products? And will there be any further inventory impairment?

The second question is I would love to know what are your recent adjustments after the stores cannot be operated exclusively?

And my last one is since the national e-cigarette online trading platform has been launched -- and I would like to know what is your latest progress with regard to the cooperation with Tobacco Administration and other entities?

Sam Tsang: Thank you, Peihang. So the first one is on the inventory level , and also our inventory impairment practice. And the second one is on the exclusivity term that we previously had with our store owners. And the final one is the latest developments regarding the transition platform.

So regarding the inventory level for our new products and require inventory impairments, there has been a gradual but steady start with sales of our new product compliant with national standards. And also our users will need more time to digest the inventories and adjust their user behavior. So the inventory level for our new products is relatively low compared with the level that we had for older series before the transition period.

And regarding the inventory positions, we have been incurring inventory positions for our products that do not comply with new national standards, and raw materials that are no longer applicable since the fourth quarter of 2021. We don't expect we will incur more significant inventory provisions regarding products in compliance with national standards in the coming quarters.

And the second question is on the exclusivity term that we had for store owners previously. After the STMA announced the rule that the exclusive distribution agreements are not allowed for brand partner stores in March 2022, we began terminating our agreements with store owners and returning their deposits. So as of the end of second quarter, most of this work has been completed.

In our view, the non-exclusivity will enable us to access stores that previously carried out only other brands. In the future, brands with substantial brand equity and user mind-share, i.e. RELX, there still be favored by store owners, as such products will help them to improve their store's productivity. Based on our own observations, since the termination of the exclusivity, many additional store owners have started selling RELX-branded products.

And finally, regarding the process that we have for the trading platform, so from the beginning of this month, several regions across the country have begun to test the national transaction platform. As a leader in China's e-vapor industry, we were pleased to be among the first few brands selected to participate. The transition process has been smooth and we are grateful for the course provided by the STMA. For instance, our staff has been offered trainings from the research institutes quality supervision, test vendors and the clinical testing cooperation by the STMA on the national standards.

Thanks to their help and assistance, our new products were among the first batch of products in the industry to obtain approvals under the new regime. Thank you.

Peihang Lv: That's very clear. Thank you very much.

Operator: Due to time constraints now, I would like to turn the call 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 through the contact information provided on our website or TPG Investor Relations.

Operator: This concludes this conference call. You may now disconnect your line. Thank you.