

RLX Technology Inc.
Q3 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, and thank you for standing by for the RLX Technology Third Quarter 2022 Earnings Conference Call. (Operator Instructions). 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: Thanks very much. Hello, everyone, and welcome to RLX Technology's third 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 <https://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 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 Chao. Please go ahead.

Chao Lu: Thank you, Sam. And thanks, everyone, for making time to join our earnings conference call today. During the third quarter, we remained dedicated to preparing for a smooth transition to the new operating environment created by China's new national standards, which came into effect on October 1, 2022. Specifically, we concentrated on developing new products in compliance with the national standards, which we call Guobiao or GB products, and finished moving our sales to the national transaction platform. We started this transition in late August during the national transaction platform trial phase in selected regions, and have now achieved full geographical coverage nationwide, putting us on track to steadily roll out our new products to customers across China.

Before I delve further into the details of our endeavors during the transition period, I'd like to talk first about the recent industry regulatory developments. On October 25, the Ministry of Finance, General Administration of Customs, and State Taxation Administration jointly issued the Announcement on Imposing Consumption Tax on E-cigarettes, which came into effect on November 1, 2022.

The new law imposes a consumption tax on manufacturers, importers and/or distributors of e-cigarettes in China, representing another landmark event in the legalization and standardization of China's e-cigarette industry following the adoption of the e-cigarette mandatory national standard and Measures for the Administration of E-Cigarettes earlier this year.

With the implementation of the new taxation policy alongside the relevant laws and regulations on e-cigarettes that have been rolled out over the past 2 years, we can see that China's regulatory framework is becoming clearer, guiding the industry to a new era of healthier development with better oversight and management. We firmly believe that the new regulatory framework will benefit all industry participants' long-term development, and as always, we will strictly comply with all applicable regulations.

At the same time, the new, fast-evolving operating environment creates some challenges for industry participants, as well as a short-term adverse impact on our performance as we actively adjust our products and operations. Despite these near-term obstacles, we remain confident in our business's resilience and the growth potential of the e-vapor industry. We believe RLX will ultimately benefit from the more structured regulatory environment, and emerge stronger after we adjust our business and adapt our products and strategies for success in this new era.

Now, let me provide some more details on our efforts and achievements during the transition period. Since the formal rollout of the new rules and regulations earlier this year, we have proactively responded through public channels, adjusted our business and conducted our operations in accordance with all applicable requirements. For instance, under the guidance of the competent authorities, we increased communication and strengthened our internal training on

the regulations and the new standards. In addition to deepening our team's understanding of the regulations, we also actively provided timely support for store owners and distributors during the transition period to ensure a smooth transition for the whole value chain.

At the same time, we accelerated our research and development of the new GB products and actively applied for technical reviews and relevant licenses. These efforts continue to bear fruit. As we reported last quarter, several of our GB products were among the first batch in the industry to achieve approval. These products have now been brought to market and are achieving steady sales. We have a healthy pipeline of products in the development, and are carefully monitoring user feedback on newly-released products to ensure that our future products meet their needs.

As of the end of last week, we have obtained approval for 14 devices and 14 cartridges, expanding the number of our GB products in our ready-for-market pipeline. Just as we did in the pre-regulation era, we are striving to provide products catering to distinct user groups with differentiated preferences and price sensitivity. For instance, we have Qingyu, an affordable device for value-conscious users, and Phantom device, our classic device product that features a new compliant child lock. Also, we have released an upgraded Phantom Pro device equipped with adjustable power. Lastly, Zeus, our ultra-premium device boasting adjustable power and resistance levels, is perfect for experienced adult smokers.

Consequently, despite the external environment continuing to evolve rapidly and the uncertainty persisting, we believe there is a growth potential in the e-vapor industry still waiting to be unleashed. We are convinced that e-vapor products will continue to play a vital role in harm reduction for adult smokers, and that with our team's hard work and innovation, we will create and deliver satisfying GB products for adult smokers across China in the new regulatory era.

Hence, supported by our industry-leading technology and research capabilities, we plan to introduce our new GB products on a rolling basis, as we assess the impact of the new tax regulations on sales as well as user feedback regarding our product innovations.

Aligned with our strong commitment to user satisfaction and regulatory compliance, we also focused on fulfilling our social responsibilities, which we see as one of our core competitive advantages. We recently published our third annual corporate social responsibility report, summarizing our achievements with respect to market responsibility, R&D investment, environmental protection, employee career development, and corporate governance over the past year.

Let me go through some of the report's highlights. Since the Company's inception, R&D investment has always been one of our strategic priorities. To keep RLX at the forefront of innovation, we have developed a “1+4” science research chain covering product quality, physiochemical research, toxicology research, long-term impact assessment and clinical research.

In March 2021, we launched the first e-cigarette clinical research project in China; and in February 2022, we commenced the first clinical study on the safety of e-cigarettes in China. Both projects were successfully registered with the Chinese Clinical Trial Registry.

Additionally, various research projects, led by RLX in collaboration with renowned research institutions, were published in prominent academic journals, such as the Chinese Journal of Drug Abuse Prevention and Treatment. These achievements, among others, have firmly cemented our industry-leading position in e-vapor R&D.

Environmental protection is another area where RLX shines. We strongly advocate for sustainable consumption and encourage our users to participate in our Pods Reborn program, which we started in September 2021. Through the consistent efforts showcased in our CSR report as of June 2022, the program had been implemented in 188 cities in China, with over 16,000 stores boasting used pods recycling bins.

We are very pleased to report that based on S&P Global's most recent annual Corporate Sustainability Assessment, our S&P Global ESG score ranked ahead of 67% of our global peers. Also, our MSCI ESG rating has been upgraded from triple-C to A rank in the top-five in the tobacco industry globally, representing a powerful commendation of our commitment to sustainability and ESG best practices.

In more than 4 years of entrepreneurship, our dedication to fulfilling our social responsibility is one of RLX attributes of which we are most proud. It is not only our duty as good corporate citizens; it is an integral part of the Company's ethos and the role we play in the world we all share. Looking ahead, we will continue to uphold our commitment to social responsibility while driving sustainable development along our entire value chain.

I will now provide a summary overview of our financial results for the third quarter of 2022. The third quarter was a transitional period for RLX as we actively adapted our business to the new regulations, and strictly conducted our operations in accordance with applicable requirements.

Amid the complex macro environment, we delivered net revenues of RMB1.0 billion in the third quarter, recording a sequential decrease mainly due to the discontinuation of older products during the transition to national standards, as well as the second quarter's high base resulting from the frontloading of sales in anticipation of this discontinuation of older products. Also, our shift to the national transaction platform was conducted on a regional basis, meaning that we also had to roll out our GB products gradually and region-by-region, limiting the pace of availability in some areas.

Although we are experiencing short-term headwinds with respect to our sales performance, we believe our diverse and growing product portfolio will continue to satisfy adult smokers' needs, and drive a gradual recovery in sales as users consume their inventories of older products.

Moving to our gross profit, we delivered profits of approximately RMB522 million with a gross margin of 50% in the third quarter, compared with 39.1% in the same quarter of 2021. The increase was primarily due to a favorable change in the channel mix. During the transition period, we gradually terminated our partnerships with distributors who could not obtain a wholesale license, which led to an increased sales contribution from direct supply to stores. A decrease in direct costs related to promotional activities was also a factor.

Against the backdrop of macro-economic headwinds and the pandemic's resurgence, we continued to focus on factors within our control, strengthening our execution and getting our

house in the best shape possible to move forward in the new regulatory era. Operational excellence is always a good business practice, and it becomes more critical in times of economic turbulence.

Since the beginning of the year, improving operating efficiency has been a key focus for our management as we seek to navigate uncertainty with certainty. Our ongoing efforts to enhance cost management once again proved effective in the third quarter, evidenced by a decrease of 30.9% in the absolute amount of our non-GAAP operating expenses compared with the second quarter, representing our second consecutive quarter of reduction. We believe non-GAAP metrics may better reflect our efforts and achievements with respect to operational improvement during the quarter.

Our GAAP operating expenses increased to RMB56.8 million from positive RMB241.3 million in the same quarter of 2021, primarily due to the change in share-based compensation expenses.

Specifically, our selling expenses were RMB52.5 million in the third quarter of 2022 from RMB56.5 million in the same period of 2021, primarily due to the fluctuation of share-based compensation expenses while offset by the decrease in branding materials and shipping expenses.

General and administrative expenses were positive RMB41.7 million in the third quarter of 2022, compared with positive RMB253.2 million in the same period of 2021. The change was primarily driven by the fluctuation of share-based compensation expenses.

Research and development expenses were RMB46 million in the third quarter of 2022, compared with positive RMB44.6 million in the same quarter of 2021. The change was primarily driven by the fluctuation of share-based compensation expenses.

Our non-GAAP net income was RMB328.6 million in the third quarter of 2022, compared with RMB452.7 million in the same period of 2021.

Non-GAAP basic and diluted net income per ADS were RMB0.247 and RMB0.246, respectively, in the third quarter of 2022, compared with non-GAAP basic and diluted net income per ADS of RMB0.334 and RMB0.332, respectively, in the same quarter of 2021.

Moving to our balance sheet, we maintained a solid cash position in the third quarter. Our cash position remained strong with cash and cash equivalents, restricted cash, short-term bank deposits, net, short-term investments, and long-term bank deposits, net of RMB16.4 billion as of the end of September 2022, compared with RMB14.7 billion a year ago.

In conclusion, in the face of challenges in the operating environment as well as the macro headwinds, we will remain committed to mitigating the effect of external forces by controlling the factors we can control. With the application of a 36% consumption tax to e-cigarettes manufacturers since November 1, 2022, we expect that the steady rollout of new products, and the price hikes necessitated by the consumption tax, will impact both sales and profitability in the future and that end demand will take time to recover as customers acclimate to the new flavors and form new habits.

Therefore, effective cost control measures will remain our priority in the short term, as we continue to stimulate sales with enticing new GB products for adult smokers.

We remain confident that our business's resilience and operational excellence will empower us to navigate the challenges as we explore new opportunities for growth and development. Meanwhile, we believe all industry participants across the value chain will work jointly to overcome this challenging time and adapt to the paradigm of the new era. Although all industry players, including RLX, will experience short-term fluctuations, as a result, we believe this regulation will ultimately facilitate the sector's long-term sustainable development.

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

Questions and Answers

Operator: Thank you. And ladies and gentlemen, at this time we will conduct the question-and-answer session. (Operator Instructions). Lydia Ling with Citi.

Lydia Ling: Thanks for the presentation. So this is Lydia from Citi. So I have two questions. The first one is on the tax impact, as the CFO just mentioned. Actually, we expected the tax impact. And so maybe could you quantify like what could be the potential financial impact on our sales and also the profitability after the tax imposition?

We noticed that you have the price adjustment as through channel trend. And so how does the margin will look like to the company and also your channel partners? And also we would like to hear your views on your normalized margin outlook in the mid-to-long-term. And so this is on the tax part.

And my second question is on your new products. And as like the national standards came into effect since October and also new products into the market for some time, so could you share with us some user feedback on your new products and also any color on the sales-through? That would be very helpful.

Sam Tsang: Thanks very much, Lydia. So the first question is mainly on the margin outlook and also the pricing after the tax regime. And the second one is mainly on the new product feedback. So the first one, as an e-vapor brand manufacturer, we're subject to a 36% consumption tax. And the additional consumption tax will inflate our cost of goods sold. As we have highlighted in our prepared remarks, we expect the consumption tax will negatively affect our profitability in the coming quarters.

On the other hand, with the implementation of the consumption tax, we have adjusted our pricing of our products accordingly, which could help to mitigate the impact of the consumption tax. So for our channel partners, taking our cartridges as an example, we expect that after the price

adjustments, their absolute amount of gross profit per cartridge will still be higher than that of our competitors' products.

And regarding a more medium or normalized margin outlook, it's difficult to give quantitative guidance at the moment, as it's still affected by several factors, for example, how our consumer behave and also our efforts to improve our supply chain efficiency. So what we could share now is that even though our gross margin will face some pressure from our consumption tax, which will be put with costs, we are still committed to improving our cost structure, and will do our best to mitigate the impact on our bottom line as much as possible.

So regarding your second question on the new product feedback, as these national standard products gradually launch with different SKUs on a regional basis province-by-province, so consumers in some of our regions or province may not have the access to our full product portfolio. As we expected, it will take some time for consumers to adapt to some of these new flavors. Our recent consumer service suggests that the NPS, i.e., Net Promoter Score, of our new products is improving every month.

So regarding your last question around about the sell-through, we are seeing a similar trend as well. And also, with more products and SKUs being launched in the market, the portion of consumers who would like to try and use our products continues to grow as well. Thanks very much for your question.

Lydia Ling: Thank you.

Operator: Charlie Chen with China Renaissance.

Charlie Chen: I have two questions here. The first one is regarding the channel inventory. I remember last time, you mentioned that you expected the China inventory of old products' distributor or consumers' level should be exhausted by somewhere around December. So how do you think the progress right now, or do you still think December will be the month that the older China inventory will be completely depleted? How does that compare with your original expectation?

My second question is on your company's sales, monthly sales, actually. Do you see a month-on-month sales recovery since October when the new regulation started to be implemented?

Sam Tsang: Thanks, Charlie. The first one is mainly on whether the actual results of our channel inventory meet our expectation. And also the second one is about how the sales trend in recent months. So regarding the inventory of our channels, so for our last earnings call, we expect that these channel inventories will be digested in 6 to 8 weeks. So as we discontinue these older products during the third quarter, we expect that the current channel inventory is extremely low, and currently, consumers are consuming their products on hand. So we expect that the majority of channel inventory of older products will be consumed by our users by the end of fourth quarter. So at that point, we will have a clear picture of the consumer demand for next year.

And so regarding the recent month sales, we understand that investors and research analysts are concerned about how consumer demand has changed since we adjust the pricing of our products to accommodate the change of consumption tax, together with the change of our products from

older generations to GB products. But honestly speaking, as it only the 16th of November, together with the first week of October, is the Golden Week holiday, it's difficult for us to provide an apple-to-apple comparison at the moment. Thank you for your question.

Charlie Chen: Thank you.

Operator: Peihang Lv with CICC.

Peihang Lv: This is Peihang at CICC. My first question is what are the differences between the Phantom Pro's use and original products with regard to target customers and positioning strategies?

And my second one is recently, we have noticed that the purchase rate of national standard products might not be very optimistic. So could you please share some causes for this? And also some e-cigarette users might change back to use cigarettes. So how will be the churn rate from your perspective?

Sam Tsang: Thanks, Peihang. So the first one is about our new product launch, what's the difference between our product portfolio? And the second one is about our user retention and also what's the churn, and also how users' well after the GB products being launched or introduced. So far, the first one is about the difference of products.

So the key difference between the Phantom Pro and Phantom device is that the Phantom Pro features an adjustable power. So for example, the fixed power level for the original Phantom cartage is 6.5 watts; and with the Phantom Pro cartridge and device together being used, consumer can select or range the power level that best fits their needs, where delegate stronger or less strong from 5 watts to 8 watts. This is our ultra-premium device boosting both adjustable power and also resistance level. And in our view, it is perfect for adult smokers with a longer history of smoking. So as we did in the past, so it plans a more diversified product portfolio offering various consumer segments, offering best-in-class products to various user groups' pricing capacity and also other preferences.

So your second question is about our consumer behavior, how the retention goes and also what the churn rates, whether these users have changed to use cigarettes again. So I think we are still in the process of gradually rolling out our entire product portfolio province-by-province. So therefore, I think the accessibility and availability of products are factors that will affect our consumers' purchase journey and also their retention ratio.

And also as said before, we believe that a significant portion of our consumers are still consuming their remaining inventories of our older generation of products and some haven't tried our new GB products yet. And therefore, I think the current phase of users for calculating retention rates may be distorted. And also we would like to keep in mind for both investors and research analysts that the performance of one to two or three stores may not be representative of the company's overall product performances.

And second question is regarding the shift from e-vapor back to cigarettes. And we think that this portion would be extremely limited. We believe that harm reduction and also convenience are two major factors that adult smokers try to use vapor products according to our internal

consumer survey. So while our product experience may have changed these two factors, i.e., the convenience and also harm reduction, will continue to play an important role in our user retention. So thank you very much for your question.

Peihang Lv: That's very helpful. Thank you.

Operator: And this will conclude the question-and-answer session. I'd like to turn the conference back over to management for any 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: The conference has now concluded. Thank you for attending today's presentation. You may now disconnect your line at this time.