

RLX Technology Inc.
Q4 and Fiscal Year 2022 Earnings Conference Call
March 10, 2023 7:00 AM Eastern Time

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 Fourth Quarter and Full Year 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 fourth quarter and full year 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 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, and representatives do not undertake any obligation to update these forward-looking statements 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 to Ms. Kate Wang. Please go ahead.

Kate Wang: Thank you, Sam, and thanks, everyone, for making time to join our earnings conference call today. 2022 was a year filled with unprecedented challenges. A combination of Covid-related disruptions and a substantial new set of industry regulations and policy updates impacted our operations and the e-vapor sector as a whole. We carefully evaluated the market landscape in response to the volatile environment and quickly pivoted to embrace the new policies and standards. Thanks to our effective strategy and strong execution, we maintained steady operations and achieved meaningful development during the year.

For today's call, I'd like first to review the past year's regulatory developments and highlight our efforts to respond to the new requirements before moving to our outlook for 2023 and the ESG-related activities.

Let's start with the landmark new regulations. In March and April, the Administrative Measures for E-Cigarettes and National Standards were introduced successively, embarking upon a new regulatory era for the e-vapor industry. A set of detailed guidelines, rules and measures rolled out in the following months. To ensure a smooth adjustment, the authorities granted industry participants a transition period ending September 30, 2022.

During the transition period, we proactively adapted our business and prepared to comply with the new requirements when the regulations came into full effect on October 1, 2022. We focused on designing compliant new products -- we call it Guobiao in Chinese, or G.B. products -- and applied for the relevant licenses and approvals. We readied ourselves to move all of our sales to the National Transaction Platform as required. Meanwhile, we strove to optimize our supply chain and streamline our organization, enhancing the company's agility and flexibility to better respond to the evolving regulatory environment as well as Covid-related disruptions.

In addition to our internal adjustments, we also provided timely support for our store owners and distributors to facilitate a seamless transition for our whole value chain.

These actions proved effective and positioned us well to enter the new period. Importantly, in June and July 2022, two of our subsidiaries obtained the License for Manufacturing Enterprise from the State Tobacco Monopoly Administration. Specifically, one received approval to manufacture e-liquid, and the other received approval to own the RELX brand and manufacture RELX-branded e-vapor rechargeable devices, cartridge products, and other relevant products.

We also gradually discontinued our older products and began launching our approved new products in an orderly fashion nationwide, while successfully moving our sales to the national transaction platform.

We now offer four distinct lines of compliant devices across various price points to meet the needs of diverse groups of adult smokers, from price-sensitive customers to those who value

premium finishes and personalized experiences. We are also gradually rolling out new cartridges to elevate our customers' smoking experience. We are delighted to see an increasing number of adult smokers using our new G.B. products.

As we forged into the fourth quarter, we encountered another challenge, the Excise Tax on E-cigarettes, which was introduced on October 25 and enacted on November 1. As an e-vapor manufacturer, we have been subject to a 36% excise tax on our distributors' sales since then, adversely impacting our margins. In response, we have further adjusted our cost structure to enhance our efficiency and maintain our profitability at a healthy level. Our CFO will elaborate this a bit later.

Although these regulations and policies challenge our company and the broader industry in the near term, we believe they also create order and a healthy operating environment that will benefit all industry participants in the long term.

Moving forward to 2023, we intend to reap the benefits of the clearer regulatory framework and China's reopening by leveraging three of our core competencies. The first is product development. Our industry-leading R&D capabilities and ongoing investments in scientific research enable us to swiftly develop and launch compliant products that meet evolving consumer needs and preferences. Our non-GAAP R&D expense ratio has grown from less than 2% 3 years ago to 5.7% in 2022. Recently, we offer the most diversified product portfolio in the market, catering to various demands of adult smokers. We believe our R&D advantages will enable us to maintain this leadership in the post-regulatory era.

Second, product quality and brand equity. For most e-vapor users, the RELX brand is synonymous with quality in e-vapor products, especially for devices that heat e-liquid into an aerosol inhaled into the lungs. Quality matters to adult smokers, and it is paramount to RLX. We will continue to focus intently on this cornerstone of our brand.

Finally, we will rely on our business resilience and strong execution. This is not the first time we have encountered changes and challenges in the industry. Back in 2019, a ban on online sales of e-vapor products forced us to change our strategy overnight. We quickly moved offline, pivoted to our branded stores plus model, and won the favor of adult smokers with our unique combination of convenience, value, and outstanding products. Thanks to our team's creativity, our robust business fundamentals, and a mountain of hard work, we are also steadily moving past the obstacles posed by the new regulations.

Before I conclude, I'd like to share some updates on our ESG initiatives. Alongside our efforts to develop our business under the new regulatory framework, we remained devoted to fulfilling our social responsibility in 2022. For example, our Pods Reborn recycling program, which we started in September 2021, has achieved several meaningful milestones. As of the end of 2022, over 10,000 stores in 282 cities nationwide had joined the program, with over 2.8 million cartridges collected. Those recycled pods are centrally processed into cement clinkers, an intermediary product in cement production, which we then use to construct roads, bridges, and toilets in rural revitalization projects. This eco-friendly approach allows us to reuse precious resources to provide better homes for rural villagers. In December 2022, our Pods Reborn recycling program

was named an innovative enterprise for rural revitalization at Southern Metropolis Daily's 2022 ESG Annual Ceremony, a prize awarded to China's most forward-thinking ESG programs.

Furthermore, we have integrated United Nations' Sustainable Development Goals into our social responsibility strategies. In April 2022, we launched our net-zero emissions plan, Aim for Zero, to achieve carbon neutrality in our direct operations by 2033 and along the value chain by 2050. We plan to launch zero-emission products and zero-emission factories, establish a green supply chain partnership, eliminate unnecessary single-use plastic packaging, and reduce waste to achieve our goal. We also encourage employees to adopt low-carbon office practices to promote realizing the company's carbon neutrality commitments throughout its value chain.

Dedication to corporate social responsibility has been one of our core values since our inception. We will continue to seek new and innovative ways to deepen this commitment to our society.

In summary, 2022 was a tough year for RLX and the entire e-vapor industry. Nevertheless, we believe our efforts and progress throughout the year will pave the way for a better 2023. As China reopens and the industry adjusts to the new normal, we will remain committed to offering premium products with superior performance to satisfy adult smokers' needs. We are confident that our core competitive advantages will empower us to seize opportunities and unleash our growth potential as we continue to lead the industry in this new era.

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

Chao Lu: Thank you, Kate, and hello, everyone. I will now provide an overview of our financial results for the fourth quarter and the full year of 2022. We concluded an unpredictable full year 2022 with an especially challenging fourth quarter. Not only was it our first quarter under the new regulatory framework, it also coincided with substantial changes in China's Covid conditions and policies. Amid the complex environment, we continued to prioritize cost control, a key component of our strategy throughout 2022, improved our supply chain efficiency and product design, and adjusted our pricing to mitigate the impact of these external influences.

In the fourth quarter, we delivered net revenue of RMB340 million. As I mentioned, our performance was negatively affected by the pandemic and erosion from illegal products resulting from the cracks of implementing the new regulations.

With respect to Covid, around 40% of the regions, including Henan, Hebei, Guizhou, Shandong, Yunnan, Jilin, Hainan, Jiangxi, etc., suspended their orders for nearly 1 month during the fourth quarter because of pandemic-related disruptions. Meanwhile, offline traffic decreased substantially due to lockdowns and the massive wave of infections nationwide, significantly impacting our sales. Encouragingly, we saw offline traffic gradually beginning to recover as the peak wave of infections passed.

The second factor was illegal flavored products. Per the national standards, only tobacco-flavored products may be sold in licensed retail stores as of October 1. We strictly comply with the regulations and have maintained our leading position in the organized market. However, our sales have been affected by illegal non-tobacco flavored products, as certain consumers are slow to adopt G.B. products while non-tobacco flavored products remain available. On the bright side,

governments across the country have increased their efforts to combat these illegal products. We are pleased to see an increase in consumer acceptance among consumers who have switched to G.B. products.

For the full year, our net revenues fell 37% year-over-year to RMB5.3 billion. The decrease was mainly due to the suspension of new product launches and store expansion during the transition period and the discontinuation of older products in the second half of 2022.

Next, gross profit. We delivered a gross profit of approximately RMB148 million in the fourth quarter of 2022, compared with RMB766 million in the same period last year. Our gross margin increased by 3.4 percentage points year-over-year to 43.6% in the fourth quarter, thanks to the improvement of our supply chain efficiency, and a decrease in inventory provision. However, the gross margin declined by 6.4 percentage points quarter-over-quarter mainly due to the November implementation of a 36% excise tax on the e-vapor product. As I mentioned, we have adjusted our prices, product design and supply chain accordingly, and achieved meaningful results. We will continue to seek other means to alleviate the impact further.

On a full year basis, our gross profit was RMB2.3 billion, compared with RMB3.7 billion in the prior year. Gross profit margin remained stable at 43%, mainly because an increase in inventory provision offset our improvements to supply chain efficiency.

Moving on to cost control, which has been our strategic focus throughout the year, our efforts in 2022 were remarkably successful and could save us more than RMB141 million annually going forward.

In the fourth quarter, our operating expenses were RMB620.4 million, compared with RMB231.5 million in the same period of 2021. The increase in operating expenses was primarily due to the change in share-based compensation expenses as a result of our price fluctuation. Excluding share-based compensation, our non-GAAP operating expenses were RMB146 million in the fourth quarter, a decrease of 23% year-over-year.

For full year 2022, operating expenses were RMB1.2 billion in 2022, a decrease of 10% from RMB1.4 billion for the prior year. Specifically, our selling expenses decreased by 33% to RMB348 million in 2022 from RMB521 million in the prior year, mainly driven by, first, a decrease in share-based compensation expenses, and second, a decrease in branding material expenses.

General and administrative expenses decreased by 14% to RMB577 million in 2022 from RMB673 million in the prior year, primarily due to the decrease in share-based compensation expenses.

R&D expenses increased by 76% to RMB317 million in 2022 from RMB180 million in the prior year, primarily due to an increase in salaries and welfare benefits partially offset by a decrease in share-based compensation expenses.

Excluding share-based compensation, our non-GAAP operating expenses were RMB1.1 billion in 2022, down 6.5% year-over-year. We will continue to concentrate on cost control in 2023.

Now turning to profitability. Thanks to our effective cost management and strong execution, we maintained a healthy level of profitability during 2022.

Our non-GAAP net income was RMB250 million in the fourth quarter of 2022, compared with RMB537 million in the same period of 2021.

Non-GAAP basic and diluted net income per ADS were RMB0.188 and RMB0.186, respectively, in the fourth quarter of 2022, compared with non-GAAP basic and diluted net income per ADS of RMB0.398 and RMB0.394, respectively, in the same period of 2021.

For the full year 2022, our non-GAAP net income was RMB1.6 billion, and non-GAAP margin improved slightly by 3.1 percentage points to 29.5% in 2022.

Non-GAAP basic and diluted net income per ADS were RMB1.218 and RMB1.210, respectively, in 2022, compared with non-GAAP basic and diluted net income per ADS of RMB1.604 and RMB1.595 respectively in the prior year.

Moving to our balance sheet. As of December 31, 2022, we had cash and cash equivalents, restricted cash, short-term bank deposits, short-term investments, long-term bank deposits and long-term investment securities of RMB15.73 billion, compared with RMB14.86 billion as of December 31, 2021.

As we embark upon 2023, we will continue to optimize our operational efficiency and cost control measures, enhancing our agility and ability to compete amid the new regulatory environment. Our strong cash position will also empower us to make quality investments in R&D and product development. We believe our company's resilience and solid fundamentals will enable us to overcome near-term hurdles and thrive in this new era. As always, we remain dedicated to creating long-term sustainable value for our stakeholders.

This concludes our prepared remarks today. Please refer to our earnings press release for further details of our fourth quarter and full year 2022 financial results.

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 Research, and so I have two questions here. The first one is could you share about your recent trend like in January and also February? And what's the user feedback on your new products and also these new prices? And given the reopening and also government efforts on the counter of illegal products, so how do you expect your demand would recover to which level this year? So this is my first question.

And my second question is on the margin side. So as a result of the price increase adjustments along the value chain and also including like consumption tax impact, so how do you actually expect your margin trends this year and also in the long term?

Sam Tsang: Sure. Thanks very much, Lydia, for the questions. So the first one is about how demand will evolve and also the user feedback. And the second one is mainly on the consumption tax and how are the margin trends. So regarding the first one, which is the demand outlook and also the user behavior, so we recently do see a sequential improvement month-over-month and we believe there are a few reasons.

So the first one is about conversion. As users consume their pre-G.B. products, so they will naturally purchase G.B. products that's produced by us, as these products has been their major source of nicotine consumption. And the second is the launch of more SKUs. As we have gradually launched more SKUs with various tobacco flavors to the market, users could be more accessible to find their preferred choice of tobacco-flavored cartridge.

And regarding our full year outlook and also the level of recovery, to be honest, I think right now, it's still very early and difficult to provide accurate quantitative estimates for the reasons that we mentioned earlier in the remarks. The availability of illegal products, to a certain extent, have delayed the conversion process for our users switching from pre-G.B. products to G.B. products that comply with the national standards. But recently, we do see there are improvements as the STMA has initiated a campaign to combat non-G.B. illegal products on a largely scale and we are truly supportive of such campaigns. So we do see, and we expect to see, more users switching to tobacco-flavored G.B. products that would comply with the recent requirements once the majority of non-compliant products has been removed from the market.

And regarding the user behavior, as we mentioned in the last earnings call, we see that the Net Promoter Score, i.e., the NPS, has been improving once users have more frequently used the products; and also the launch of more SKUs with various tobacco flavors, having a range of product offerings could further enhance our products' NPS.

And in terms of our pricing, we have also made the first price adjustment on our ex-factory selling price and also the suggested retail price following the impose of consumption tax in last November. So most of our users have adapted to the change, given that our products are their necessity. But we also see that there are a small portion of users that the pricing may be a bit high for them. So considered our ongoing supply chain efficiency improvements and also these user needs, we will adjust our product pricing for certain SKUs starting in April. And also, we have provided various product offerings with various price points, including the entry-level products like QING YU to be more accessible for our products by bringing them to market in more provinces. For example, we offered QING YU in 23 provinces in January this year versus 16 provinces in last year's November. So we do see a recovery in demand.

And regarding your second question about the consumption tax impact and also the margin trend, our GPM actually fell by 6.4% quarter-over-quarter last quarter, mainly due to the impose of consumption tax, which took effect on November 1. So investors and analysts could see a more full picture regarding the effect of our consumption tax in the first quarter of 2023. And of course, we have already taken some steps to mitigate the impact. So first, we have adjusted our

ex-factory selling price. And second, we have continued to improve our supply chain efficiency and product design to lower our variable unit costs. So these two initiatives have helped us mitigate the impact due to the impose of consumption tax.

Although we have adjusted the price and lowered our unit costs to partially protect our gross margins, we would like to remind analysts and investors that we also have incurred fixed costs, like depreciation in line items of our cost of revenue. So this impact attributable to our fixed cost depend on the level of recovery in our sales volume. So in the short- and medium-term, we believe our gross margin will gradually improve, mainly due to the sales volume recovery. In the long run, we will continue to improve our supply chain efficiency and product mix to further strengthen our margin profile. Thank you very much.

Operator: Charlie Chen at China Renaissance.

Charlie Chen: I have two questions as well. The first one actually is a follow-up related to the price adjustment. So you mentioned that you should have an improving gross margin. So I have two questions on this. One is, given you have done all those operating efficiencies, how do you see your operating margin going forward? And also, what's the rationale behind this price adjustments, as well as do you have any further plan for price adjustments in the future? So that's related to the price adjustments.

And my next question is regarding the share repurchase, share buyback actually. So how much you have done and what's your share buyback plan in the next few months or a year or so?

Sam Tsang: Thanks, Charlie. So the first one is about the price adjustments and the second one is about the share repurchase. So from the perspective of the absolute amount of our merchandise gross profit before deducting the fixed costs such as D&A and rental costs, the absolute gross profit amount per cartridge will decrease by mid-single-digits following the price adjustments in April if the unit cost stays the same. In the meantime, our ex-factory selling price per cartridge will decrease by an even higher degree post the price adjustments. And therefore, if mathematically calculate, our GPM will improve slightly. As our new ex-factory selling prices will be effective on April 17, 2023, we do not expect to make price adjustments in the near term.

So for the operating margins, it depends on our top line recovery. Currently, we cannot provide quantitative guidance on margins for this year, but we have already taken steps to improve our efficiency to limit the impact of reduced sales. Taking 2022 as an example, our efforts in operating cost savings could save us more than RMB140 million on an annual basis.

And the second one is about share rep. As we announced our \$500 million share rep in December 2021 for a term of 2 years, we will disclose the exact amount in our 20-F filings next month. The share rep program is largely on track with our internal plan. So our board and management will consistently monitor the capital market conditions, and will make the corresponding repurchases from time-to-time. Thank you for your questions.

Operator: Peihang Lv with CICC.

Peihang Lv: This is Lv Peihang at CICC, and thank you for your time and presentation. I have two questions to ask. The first one is how is your recent cartridge sales volume of the G.B.

standard products excluding the interference of illegal products? And could you show us some outlook for the upcoming recovery trend?

And my second question is we have noticed that your ex-factory price and retail price has been lowered recently. So I am wondering the reason for this action, and how do you project the future project the future sales volume and GPM change after the price reduction?

Sam Tsang: Thank you for your question, Peihang. So the first one is mainly on the sales due to the impact of illegal products. And the second one is about the price adjustments, what is the impact on our G.B. So I think it's difficult for us to estimate the impact due to illegal sales as these products are sold on the black market. And especially, these products are non-compliance and these entities do not pay for any tax. And therefore, they don't transact even on the national transaction platform. And that's why I think it's difficult for us to estimate their volume and also the impact on our sales.

And looking at the sales outlook for the year, if these illegal products could be mitigated on the market, what we can share on this stage is that the stores, which only sell G.B. products, for example, like our direct-owned stores, we could see that in recent months, their sales per store has been gradually improving. However, definitely, these stores are impacted by the nearby stores that sell illegal products. So we think the recovery will be even faster than our observance if these illegal products have been mitigated from the market.

And the second question is about the price adjustments that will be effective from April 2023. The main reason behind the price adjustment is that we have seen that our supply chain efficiency has been further improved, which provides some room for us to make price adjustments. And therefore, we decided to adjust our ex-factory selling price to better help our retailers to navigate the hard times alongside us. After our ex-factory selling price adjustments, their gross profit per cartridge will increase, generating higher profits at their end. Meanwhile, given that we have four product lines with various price points, these price adjustments are designed to make the gross profit margins for each series more reasonable from the retailer's point of view. This will better incentivize retailers to promote our various series of our G.B. products.

Lastly, we would like to make our products more accessible to price-sensitive users. After the adjustments, we hope to see these users who have delayed their conversions due to pricing to have better incentives to use our G.B. products. Thank you for your question.

Operator: Thank you. And due to the 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 The Piacente Group Investor Relations.

Operator: Thank you. This concludes this conference call. You may now disconnect your lines. Thank you very much.