

RLX Technology Inc.
Q1 2023 Earnings Conference Call
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Executives

Kate Wang, Chief Executive Officer

Chao Lu, Chief Financial Officer

Sam Tsang, Head of Capital Markets

Analysts

Lydia Ling, Citi

Peihang Lv, CICC

Charlie Chen, China Renaissance

Presentation

Operator: Hello, ladies and gentlemen, thank you for standing by for the RLX Technology Inc.'s First Quarter 2023 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 Capital Markets for the company. Please go ahead, Sam.

Sam Tsang: Thanks very much. Hello, everyone, and welcome to RLX Technology's first quarter 2023 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.

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 Ms. Kate Wang. Please go ahead.

Kate Wang: Thank you, Sam, and thanks, everyone, for making time to join our earnings conference call today. During the first quarter, we continued optimizing our compliant or GB product offerings under the new regulatory framework and made steady progress, thanks to our effective product strategy and constant efforts to enhance our R&D capabilities. However, as we strive to develop new, approved products to meet our users' diverse demands, the prevalence of illegal products continues to pose near-term challenges to our business and the broader industry.

First, let me provide some color on recent market conditions as affected by illegal products. Then I'll discuss our first quarter endeavors in greater detail.

The biggest obstacle we faced in the first quarter of 2023 was competition from illegal products. These include flavored products manufactured by companies that haven't yet obtained licenses, some flavored products manufactured for export that are illegally sold in the domestic market, and counterfeit products. The existence of these illegal products not only weighed on our sales but also disrupted the recovery pace of the whole industry by slowing consumers' conversion to products that meet the national standards.

But on the bright side, the government has increased its efforts to crack down on illegal products, recently conducting special operations to focus on two major offenders: manufacturing companies that continue to produce flavored products illegally and retail participants that use the internet as a distribution channel. The results of these government endeavors are encouraging thus far. We have noticed more and more unlicensed manufacturing companies deleting e-vapor products from their business scopes in their business licenses. Also, a number of retailers found distributing illegal flavored products have been fined. Our sales have gradually recovered following the execution of these special actions. Our CFO will elaborate on this a bit later.

We believe the government's crackdown on illegal products will be ongoing, and we are hopeful that it will effectively support the creation of fair and orderly market conditions, prompting a return to sustainable growth for law-abiding companies such as RLX. However, we remain vigilant on any potential rebound of these illegal activities.

Amid the first quarter's external challenges, we remained focused on strengthening our core competitiveness and pursuing high-quality development. Let's take a closer look at the details. Enhancing our product development and scientific research capabilities has always been a key element of our strategy. We partnered with Shenzhen Bay Laboratory in the first quarter to establish a new atomization technology research and development platform. Together we will explore and develop new peptide drugs based on electronic atomization technology, leveraging our deep experience and industry-leading atomization technology to improve absorption efficiency further and enhance user experience.

Furthermore, we continued to execute our proven product strategy, enriching and optimizing our product portfolio to meet the needs of different user groups. As of now, we have received approval for 20 cartridge SKUs and 22 device SKUs. Encouragingly, we have received some positive feedback and constructive suggestions from users who have switched to our new products. We will continue collecting user feedback and developing products accordingly, seeking superior performance and quality while helping adult smokers transition to GB products.

We remain dedicated to shouldering our social responsibility alongside our efforts to offer high-quality, compliant products for adult smokers. An outstanding example is our Pods Reborn program, one of our key sustainability initiatives to help reduce plastic waste. The program has grown by leaps and bounds since its inception in 2021.

As of the first quarter of 2023, we have collected cartridges from users across 297 cities nationwide. What's more, users can now use our official WeChat account to find recycling locations near them or book a pickup appointment online. The used pods are recycled into cement, then used to construct roads, bridges, and other rural revitalization infrastructure projects. As of today, we have invested millions in the first phase of our rural revitalization project, providing better infrastructures for rural villagers, while conserving precious resources.

To sum up, the first quarter was a mixed bag. While we made solid progress in improving our GB product offerings, we also experienced significant headwinds from illegal products. However, we firmly believe that as adult users gradually adapt to GB products and the government's efforts to protect market order and fairness take effect, illegal products will eventually be pushed out of the mainstream market. And the worst seems to have been behind us.

As a trusted e-vapor brand for adult smokers, we remain confident in our core competitiveness. We will deepen our commitment to providing compliant, premium products that meet our users' needs as we explore growth opportunities in the evolving industry.

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 Lu: Thank you, Kate, and hello, everyone. I will now provide an overview of our operational and financial results for the first quarter of 2023. Given the severe impact of illegal flavored products, we experienced an incredibly challenging first quarter, especially in January and February. These enticingly flavored but unsafe and illegal products caused users to shift more slowly than expected to our GB products, driving a significant decrease in our net revenues to RMB189 million in the first quarter.

However, our sales have recently shown clear signs of recovery, partly thanks to the government's large-scale operations to combat illegal products. Specifically, our monthly sales experienced sequential improvement, especially after the government's special actions in March. In fact, monthly sales almost doubled in March compared with that in January.

However, the negative impact of illegal products is still lingering, as it will take some time for the market to digest inventories, much like in the fourth quarter of last year, when it took a couple of months for users to consume our older products. The near-term challenges from illegal

products will gradually ease and become more manageable, and users will gradually adapt to GB products.

Now turning to gross margin. The first quarter of 2023 was our first full quarter under the new excise tax policy on e-vapor products, which came into effect in November 2022. As a result, our gross margin fell to 24.2% in the first quarter of 2023 from 38.3% in the same period of last year.

If we exclude the impact of excise tax, on an adjusted basis, using adjusted net revenues, which deduct excise tax we paid from reported net revenues as denominators, our adjusted gross margin fell only 1.6 percentage points. This result reflects our continued efforts to improve our supply chain efficiency and product design to mitigate the deleveraging effect of reduced sales.

Additionally, fixed costs, including the rent we paid for exclusive manufacturing plants, and depreciation we booked for PP&E, dragged on our gross margin by a low-single-digit percentage in the first quarter. Our gross margin will gradually improve along with our top-line recovery in the coming quarters, as the deleveraging effect I just mentioned will shrink.

Alongside these cost optimization efforts, we continued to focus on improving operation efficiency. As a result, excluding share-based compensation, our non-GAAP operating expenses were down by 50.1% year-over-year in the first quarter of 2023. However, due to our reduced sales, we recorded a non-GAAP operating loss of RMB133 million in the first quarter.

Furthermore, we recorded a net loss of RMB56.3 million in the first quarter of 2023. Excluding share-based compensation, our non-GAAP net income was RMB184 million in the first quarter of 2023.

Non-GAAP basic and diluted net income per ADS were RMB0.139 and RMB0.136, respectively, in the first quarter of 2023.

Our cash position remains solid. As of March 31, 2023, we had cash and cash equivalents, restricted cash, short-term bank deposits, short-term investments, long-term bank deposits, and net long-term investment securities, totaling RMB15,369 million.

Since the second half of 2022, we have been working to maximize the interest and investment income on our solid RMB15.4 billion cash position, a strategic effort now paying off. We generated RMB170 million interest and investment income in the first quarter of 2023, implying an annualized interest rate above 4%, a significant improvement from less than 2% a year ago.

Before I conclude, I'd like to provide an update on our share repurchase program. Our board of directors approved a share repurchase plan on December 8, 2021, under which we may repurchase up to US\$500 million of our shares until December 31, 2023. As of December 31, 2022, we have repurchased about US\$100 million of our shares under this program.

Looking ahead, we will continue investing in our core capabilities and improving overall efficiency. We believe our sales and profitability will gradually pick up as the industry regains momentum. Our resilient business model and solid cash position will support us as we navigate the market dynamics, enabling us to deliver sustainable value to our shareholders and stakeholders in the long term.

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 Citi. So thanks for the presentation. I have two questions. First, glad to hear that monthly sales have some sequential recovery just mentioned by CFO. So could you share some more color on the sales recovery trend in the second quarter to-date? Like how your monthly sales in April recovered so far? And also based on current recovery trend, how do you see the full year trend? Are you turning more positive or negative? Like and also want to know some like your retailers' profitability recovery so far? And this is my first question.

And the second question is on your new product. And so how many are your new products actually currently on the pipeline and plan to further rollout this year? And also, what's your view on like your competitive edge over your peers in terms of those new products? And as you just mentioned, and for the illegal product issues occurring in the market, and so how about the currently channel inventory after the regulator's crackdown? And is the level already significantly declining?

Sam Tsang: Thanks very much, Lydia. So regarding your first question, it's about the second quarter trend. As we prepared in our opening remarks, we know that there are a sequential improvement in our monthly sales, and this trend has actually continued starting from last year's November till now, i.e., April or May, due to the natural conversion of users from the older generation of products to GB products, thanks to the regulator's great action in cracking down on illegal products and the product launches of various SKUs.

So we actually made a price adjustment on the April 17 and lower our factory price of selected cartridge by mid-teens to provide better margins for retailers. And we do witness a restocking from our distributors since then.

For the full year outlook, we are confident on the overall trends as the numbers have been growing every month, but there are also uncertainties as the overall user sentiment hasn't fully recovered yet and retailers with retail license would have to decide whether or not to renew their retail license in the coming months. So I think overall, we are confident on the trend, and we maintain our internal operational targets.

And regarding our retailers' profitability, the trend of their sales of GB products has been going upwards, especially after regulators' special action in March/April. Of course, if some retailers may sell the illegal products, their sales may be affected by the special action as well. So I think it's difficult to estimate their profitability quantitatively as each of them have different fixed cost structure.

So regarding the second question is about the product pipeline and also our edge towards other brands in the markets. So regarding the product pipeline, we have already launched 20 cartridge SKUs approved in April compared with 15 in February, i.e., we have 5 increments in 2 months only. And we will gradually launch these new products on a provincial basis. And we have also a number of products submitted, or in the progress of application, in addition to the 20. And we will provide an update once we obtain the approvals.

And we have very clear and significant edge towards other brands as well. We have industry-leading R&D capabilities to innovate our distinct and great tobacco flavors for adult smokers. And unlike most of our peers, they solely or heavily rely on their suppliers. We have our own exclusive production plants and e-liquid factory, which can guarantee our product quality and undergo our strict product control protocol.

And lastly, we have the most diversified product portfolio, and we'll continue to diversify the portfolio to meet the needs of various user groups.

And regarding the illegal products, I think it's definitely not easy to estimate their level of inventory, given that it's a black market. As mentioned in our prepared remarks, we think the negative impact of illegal products is still lingering, and it could take some time for the market to digest the inventories, similar to the fourth quarter of last year, which took a couple of months for user to consume our old products. Thank you for your questions.

Lydia Ling: Thank you.

Operator: Peihang Lv from CICC.

Peihang Lv: This is Peihang at CICC, and thank you for your time and presentation. I have three questions for you. My first question is, how is your latest cartridge device sales structure of four product lines? And how is the latest cartridge to device ratio?

And my second question is regarding flavors, and what would be differentiated or the directions for each type of GB standard flavors such as Xi Yan and Pu Yan?

And the last one I have is of the district supervision and crack down on illegal products. And what is the current sales proportion for GB legit products in the market? And looking forward, what would be the following emphasize for supervision and law enforcement?

Sam Tsang: Thank you very much, Peihang. So I think the first question is about the price areas, what's the proportion. And I think in March/April, we are still gradually launching various SKUs to the markets, province by province. And the mix across each product series is largely depend on the pace of new product launches. So we recognize our revenue upon the delivery to our distributor warehouse. And therefore, if we launch a new SKU, like what we did in March/April in one particular series in that month, the self-contribution of that series will be higher than usual.

And meanwhile, as you may also aware of that, the users of our old Phantom device can still continue to use their device to consume our new Phantom cartridge. And that's why you may aware that the Phantom user base is still the majority of our four product series. And I think we

internally do not have a specific target regarding the proportion of each series. And we believe the proportion across each series will depend on the user demand in the medium term.

And regarding our second question, it's about the R&D, how do we try to differentiate our flavors? So as you may be aware, we do have four different series for our cartridge with different flavor features, i.e., the Xi Yan, which is a more Chinese-style with mild tobacco flavor; Shan Kao, a Chinese-flavored, a more balanced tobacco flavor; Yan Kao, a Chinese flavor with strong tobacco flavor; and Pu Yan, which is very similar to the overseas style with a strong tobacco flavor.

So these four different cartridge series do offer a wide range of options for our users, assisting them to select their designated choice of cartridge. So for example, if a user has a very long history of smoking, they might consider to use Yan Kao as they have a very strong kick. And for example, for users that prefer a light tobacco or cigarettes, they may prefer to use Xi Yan.

And the third question is about after the combat of illegal products, how our GB products do, and also the regulations and also the activities against the illegal products? So far, the sale of illegal products, as we mentioned before, is difficult to estimate their sizing. And that's why I think now it's still difficult to estimate the sizing for proportional-wise for GB products as well. But of course, we see that after the special action that was launched in March and April, it was very effective.

And we do observe that there is a difficulty, for users to seek for illegal products with flavors compared with before. And our monthly sales of GB products have been growing. And in the long run, we do believe that the regulators will continue to monitor markets, and crackdown illegal products on a regular basis, as these products could lead to a significant loss of tax, product safety issues and also minor protection issues.

And as a compliant e-vapor brand, we have paid 36% of excise tax with a rigorous quality-control mechanism and also a full support for minor protection initiatives. So we do expect that regulators will also closely monitor the unlicensed manufacturers who applied, but failed to obtain the license and also licensed manufacturer, which manufactured products for export, but may be illegally redirected to the domestic market. Thank you.

Peihang Lv: Thank you.

Operator: Charlie Chen from China Renaissance.

Charlie Chen: I got two questions here. The first one is about gross margin. Mr. Lu commented in the presentation that the GB margin is likely to improve with operating leverage continues. But previously, you also mentioned that you have done some supply chain optimization, as well as some product mix change? So can you give us more color on the driving factors of those three factors, like operating leverage, supply chain optimization as well as product mix change? How do those three factors drive your gross margin going forward by what magnitude, if you can?

And my second question is about the margins about your new products, as well as your newly-launched accessories, such as chewing gums and other products. So how do those products

contribute to your margins to the company, as well as how the margins of selling those products by your retailers?

Sam Tsang: Thank you, Charlie. So as we prepared in our opening remarks, so the implementation of the excise tax to pressure our GPM, and it was the first quarter of excise tax that came into the effect. And we also experienced some deleveraging effect from reduced sales through PP&E, D&A. And for future GPM trends, the most important factor would be the recovery pace of our sales. So if the sales could recover faster than what we expect, the GPM would recover more quickly. And meanwhile, the second factor would be the cost of products, which is calculated on a weighted basis. So we believe the benefits of our continued efforts improving our supply chain efficiency will be continue to more gradual.

And the second question is on the new initiatives. So thanks for your interest. And they are still at this stage with minimal revenue contribution. And we will definitely share more color with you when they can contribute a meaningful financial contribution. And currently, our new initiatives, merchandise gross margin overall are higher than that of our core e-vapor business, as they are not subject to the excise tax. Thank you for your question.

Charlie Chen: Thank you.

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 the website or TPG Investor Relations.

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