

RLX Technology Inc.
Q3 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
Charlie Chen, China Renaissance
Peihang Lv, CICC

Presentation

Operator: Hello, ladies and gentlemen, thank you for standing by for RLX Technology Inc.'s Third 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 third 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 Chao Lu, and myself.

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 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. Before I get into our third quarter results, I would like to briefly update you on our industry's macro and regulatory environment. As most of you know, it has been a year since the new regulatory framework came into effect, bringing a number of changes to the industry.

On the supply side, the new rules have pushed industry participants across the value chain to adjust their businesses and standardize their operations under the authorities' supervision. This no longer concerns some strong players, including us, who have already adapted to the new regulations and proactively developed new compliant products to meet users' needs. However, persistent irregularities among other industry participants continue to disturb the market order and adversely affect the industry's recovery, with the negative impact of illegal flavored products lingering.

On the demand side, the new regulations seem to have less impact on users and consumption. Studies have shown that most e-vapor users are still unaware of the changes brought about by the new regulations.

A survey conducted by Shanghai Jiao Tong University revealed that 40% of users now mainly use national standard-compliant products, but 17% have not even tried compliant products. Furthermore, only 40% of users said they knew that legitimate retailers are only allowed to sell tobacco-flavored products.

Users' lack of awareness of the new regulations has slowed the transition to compliant products, as has the easy availability of illegal flavored products. Educating users about the new regulations, compliant products' advantages, and the dangers of illicit products is pivotal to the industry's recovery, but this will take time and effort.

Amid this challenging environment, we continued to refine and broaden our product portfolio, while improving operational efficiency during the third quarter. I'm pleased to say that these efforts paid off, reflecting our strong execution of our effective core strategy. We narrowed our operating loss and boosted cash flow during this quarter. We're also seeing signs of sequential recovery in our top line.

Our CFO will provide the details of those results in just a moment.

Now, let me share a bit more about our strategic efforts and the progress of our product portfolio improvement. In terms of cartridges, we now offer five distinctive series of compliant devices at

various price points versus just two series, Phantom and Phantom Pro, a year ago. Last month, we launched LEILI, our 5th compliant series, featuring adjustable power at a more affordable price than Phantom Pro and Zeus. We have also quickly expanded our flavor offerings, with 17 flavors now available versus two back in October 2022.

Our wide selection of compliant products is designed to fulfill diverse demands across every user's taste and budget. We will continue to closely monitor market demand and collect users' feedback to inform our product refinements further, while leveraging our leading R&D capabilities and deep industry knowledge to develop our portfolio accordingly.

Our products' value proposition to users extends far beyond our broad product selection. First, RLX has prioritized quality control and product safety since our inception. Supported by our strong research, quality control, and safety assessment capabilities, we can guarantee higher product quality and safety. All of our products and ingredients must meet national standards and obtain regulatory approval before hitting the market.

Furthermore, as a fully-compliant participant, we greatly value users' consumption experience and provide outstanding after-sales service. If users have problems with our products, they can call our hotline or visit our stores for assistance. Our excellent customer service team can respond and address users' issues in a timely manner with professional service and efficient solutions. We also offer a one-year warranty on all of our devices and cartridges. These unique advantages add immense value to our products and provide peace of mind for users.

In contrast, illegal products are manufactured by unlicensed factories, leading to poor quality, a lack of quality control, and potential health and safety issues. Illegal products may have dangerously high nicotine concentration levels, or contain levels of lead, nickel, or chromium, exceeding the standards, as well as other banned ingredients. Illicit cartridges also frequently have oversized tanks, which can create a severe safety hazard when used in conjunction with many compliant vaping devices.

We remain confident that our growing lineup of quality products will continue to earn more users' recognition and, ultimately, their loyalty, as adult smokers realize our products' superiority and develop new habits. Meanwhile, we are trying to enhance users' knowledge of the new regulations and collaborating with regulators to combat illegal products to create a healthy and orderly market.

Before I conclude, I'd like to share that our RELX Quality and Safe Lab recently received Customer Testing Facilities certificate approval from Eurofins Technologies, becoming the first e-vapor brand in China to gain this certification. Recognition by the industry's leading authority indicates that our lab's capability of testing electrochemical appliances meets the global standard, qualifying our test results for acceptance by 54 IECEE member countries and regions worldwide. Through our ongoing efforts in scientific research and development, we continue to enhance our product safety assessment capabilities and quality control.

In conclusion, we continued to forge ahead during the quarter amid the challenging environment. We have made meaningful progress in our recovery over the past year, with an intense focus on our core strategy to develop our portfolio and enhance efficiency.

Looking ahead, we see external headwinds persisting, especially the lingering negative impact of illegal products and the uncertainties in the consumption environment. As such, we will deepen our commitment to offering compliant, high-quality products to adult smokers and educating users on their various benefits.

Meanwhile, to catch potential growth opportunities in the international market, on November 10, 2023, we terminated an existing non-commutation agreement with Relx Inc., which had been entered into on December 16, 2020. Terminating this agreement gives us the flexibility to build an international presence in the future by conducting tobacco harm-reduction product business outside China.

As we move into 2024, we believe our expansion into international markets, effective product strategy and resilient business model will propel our recovery, positioning RLX for long-term growth and sustainable value creation.

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. Before we start the detailed discussion of our financials, please note, unless otherwise stated, all the financials we present today are in renminbi terms. I will now provide an overview of our operational and financial results for the third quarter of 2023.

Against the challenging backdrop Kate just described, our total revenue was down 59% year-over-year. However, this represents a significant narrowing from last quarter's 83% year-over-year decline. While the sales of our compliant products continue to be impacted by illegal products in the market, we noticed a quarter-over-quarter increase in device shipments, indicating that the demand for e-vapor products is still growing.

On the other hand, cartridge shipments remained slow, as many users still use illegally-compatible flavored cartridges in conjunction with our compliant devices. We want to remind our users that using illegal cartridges may damage our devices and void the warranty. Due to their poor quality, illegal cartridges often suffer severe leakage issues that can ruin devices and may cause other safety hazards.

As a fully-compliant participant in the e-vapor industry, we are dedicated to promoting the industry's recovery and long-term, healthy growth. To that end, we continue to encourage users to call 12313 if they find anyone selling illegal products. We are also conducting user education campaigns to increase awareness of the regulations and the dangers of illegal products. We hope these efforts will effectively reduce the sale and use of illegal products while better protecting every user.

Turning now to profitability. In the third quarter, our gross profit margin remained stable at around 25% due to the unfavorable change in our revenue mix. However, on a like-for-like basis, our gross profit margin for our core e-vapor business to provincial distributors continued to improve quarter-over-quarter, thanks to our cost optimization initiatives and product design improvements. We are confident these efforts will continue to drive improvements in our gross margin.

Since the introduction of the new regulation framework, we have been actively adjusting and streamlining our businesses and implementing stringent expense controls for greater overall agility. I'm happy to report that, as a result, our non-GAAP operating expenses decreased by 27% on a quarterly basis.

It's also worth noting that our non-GAAP operating expenses decreased by 48% compared with the same period last year. Moreover, we reduced our non-GAAP net operating loss to just 15 million from 133 million in the first quarter of 2023 and 67 million last quarter.

Our non-GAAP basic net income per ADS was 0.149, and non-GAAP diluted net income per ADS was 0.146 for the same period. We remain confident that our profitability will continue to rise in the upcoming quarters as we strive to enhance our supply chain and operational efficiencies.

Encouragingly, we maintained positive operating cash flow for the second consecutive quarter, with operating cash inflow of 67 million in the third quarter of 2023, mainly due to improved management of our working capital and inventory.

Our cash position remains strong. As of September 30, 2023, we had cash and cash equivalents, restricted cash, short-term bank deposits, net, short-term investments, long-term bank deposits, net and net long-term investment securities, net totaling 15.1 billion. Our strong cash position will continue to support us in navigating the market dynamics. We aim to achieve additional cost savings and efficiency enhancements to accelerate our recovery.

Lastly, we are very pleased to report that our Board of Directors has approved a cash dividend of US\$0.01 per ordinary share or US\$0.01 per ADS, to holders of ordinary shares and holders of ADSs.

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: This is Lydia from Citi. So my first question is regarding your overseas development. As just mentioned, you had terminated non-competition agreement with Relx Inc. So what's the rationale that you consider to extent like export overseas expansion at this point? And how it works with the existing overseas business by your parent company? And do you have any detailed plan or target for our overseas business that you could share to us? And also, how do you think about the potential upside to our company? So this is my first question.

And the second question is happy to see the cash dividend declaration. So how do you consider the payout ratio? And what's the dividend policy looking forward?

Sam Tsang: Thank you very much, Lydia. So the first question is on the international expansion and the second one is on the dividend. So RLX only operated its e-vapor business only in China due to regulatory uncertainties and a relatively low social acceptance in the overseas market when it was its IPO. But in the last 2 to 3 years, we have witnessed positive developments globally that's changed our decision.

First, many countries have established an encouraging and stable regulatory framework for this category becoming attractive and stable markets for leading and compliance brand to enter and develop a presence. Second, global adult smokers are increasingly perceiving e-vapor products as a mainstream, effective harm-reduction nicotine alternative, evidenced by growing user penetration in many regions. These two external developments have been highly encouraging.

For RLX itself, our franchise has become a household name with clear national market leadership. Internally, we have upgraded our organizational capabilities with adequate capabilities and resources to expand our franchise to areas outside China. To achieve our mission, we decided to terminate our non-competition agreements with Relx Incorporation, which enable us to seize growth opportunities in the international markets, and establish a significant global presence outside China. We will share more details on our international expansion in the coming quarter.

So regarding your second question is on our dividend policy, as indicated in our earnings release, our Board approved our first cash dividends of US\$0.01 per ordinary share or per ADS to reward our valued shareholders' continuous support. Despite macro volatility and uncertainties, we are highly confident in our franchise future, building on our international expansion, steady profit generation, robust operating cash flows, and adequate capital reserve.

The cash dividend and our announced share buyback program demonstrated our confidence in our prospects and commitments to returning shareholders, despite the short-term volatility in the stock markets. We plan to maintain a consistent and sustainable dividend payout policy that may grow progressively with our earnings. Thank you for your questions.

Lydia Ling: Thank you.

Operator: Charlie Chen with China Renaissance.

Charlie Chen: I have two questions here. The first one is about the industry. I can see the company actually grow revenue by roughly like 10% or so quarter-on-quarter. So I think in the past few quarters, China's e-cigarette industry experienced kind of the regulators' crackdown, resurrection of illegal products, etc., etc. So I just wanted to have some color. What do you think will be the normalized industry growth going forward, or is that too early to say or you have kind of seen a setup pattern of the future growth of this industry? So that's the first question.

And my second question is with all those cost-saving effort, we can see your company's non-GAAP EBIT margin loss has narrowed quarter-on-quarter. So originally, in the past, we recall

that management guided or aimed to have breaking even non-GAAP EBIT margin in the fourth quarter. So do you still think this target is achievable based on current circumstances?

Sam Tsang: Thank you very much, Charlie. So the first question is on the growth of our industry and the second one is on the profitability of our company. So I think the user demand for national standard products has improved overall compared to what you mentioned in March 2023 before the regulators initiated a special crackdown on illegal products. However, after the special action ended, our industry faced waves of challenges from illegal products, as their illegal sales have become more secretive. At the beginning of this year, retailers would publicly display illegal products on shelves. Now, after the special action, they only sell these products to users they are familiar with.

Therefore, it's difficult to accurately estimate the demand for this category and predict the need for the national standard products. We are confident in our regulated enforcement, and believe more users will gradually use national standard products in the medium and long-term.

So regarding your second question, I think as discussed in our second quarter earnings conference call, we have significantly optimized our cost structure and streamlined our operations over the past few quarters. As a result, the absolute amount of our gross profit improved by 7% quarter-over-quarter. And our non-GAAP operating expenses for the third quarter decreased by 27% quarter-over-quarter and 48% year-over-year.

With our top line recovery and cost reduction efforts, we realized positive non-GAAP operating profit in September. We expect our non-GAAP operating profit to remain positive in the fourth quarter if our top line and cost structure don't change significantly in this or next month. Furthermore, our operating cash flow has been positive for 2 consecutive quarters.

In the third quarter of 2023, we achieved an operating cash inflow of RMB67 million compared to a RMB41 million inflow in the second quarter and a RMB231 million cash outflow in the first quarter, demonstrating our ability to adapt to the changes in macro and industry development quickly. Thank you for your question.

Operator: Peihang Lv with CICC.

Peihang Lv: This is Peihang at CICC. I have two questions here. The first one is about the product. Could you give us some color on the sales of the recent approved GB products in the third quarter? And how is the sales proportion for each major product?

And my second question is about the channel. After the renewal of retail license, what is the most updated number of domestic outlets? And how is their profitability and their operating situation from your perspective?

Sam Tsang: Thank you very much, Peihang. So the first question is on our new products, and the second question is on the retail outlets that we have. So for the first question, our user survey actually shows that two flavors that we launched a couple of months ago, Shan Shui Ren Xing and Rao Zhi Qing Wu, are becoming increasingly popular among users. These flavors are now available at most stores nationwide. And in October, the sales contribution of these two flavors to our Phantom series has already reached the mid-teens.

Additionally, Shan Shui Ren Xing's net promoter score now ranks #3 among our Phantom series, just slightly behind our best-selling Lv Shan Ying Ying and Wang Jiang You Jing flavors. We anticipate that the sales contribution of Shan Shui Ren Xing and Rao Zhi Qing Wu will continue to rise. And in October, we also launched our 5th cartridge series, LEILI, which is compatible with our Zeus device, but are more affordable than Zeus cartridges. By the end of October, we have launched the LEILI series in more than 17 provinces.

And regarding your second question, it's about the number of retail outlets. The number of retail outlets has remained stable in the past few months, following regulators' special cracking down on illegal products. Furthermore, more users have begun trying compliant products. As we explained in our opening remarks, only 40% of participants were aware that after October last year, retailers could only sell tobacco-flavored cartridges legally.

As more and more users gradually become aware of the new regulations and the benefits of national standards, such as required approvals before product launches and the assurance that all ingredients in the e-liquid are on the white list, they will be increasingly interested in using national standard products. This will improve our retailers' productivity and enhance their profitability. Our self-operated stores' profitability could reflect the overall sales profitability. These stores' profitability has been increasing quarter-over-quarter, and they have started to turn profits on the operational level in the past couple of months. Thank you for your questions.

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. Thank you.

Operator: This concludes the conference call. You may now disconnect your lines. Thank you.