CooTek Inc. [CTK]
Second Quarter 2019 Earnings Conference Call
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Company Representatives:
Christian Arnell; Christensen & Associates; IR
Karl Zhang; CooTek Inc.; Chairman and Chief Architect
Jean Liqin Zhang; CooTek Inc.; Chief Financial Officer

Analysts:
Ivy Ji; Credit Suisse
Hans Chung; KeyBanc Capital Markets
Vicky Wei; Citibank

Presentation:

Operator: Good day, and welcome to the CooTek second quarter 2019 unaudited results conference call. All participants will be in listen-only mode. (Operator Instructions) After today's presentation, there will be an opportunity to ask questions. (Operator Instructions) Please note this event is being recorded.

I would now like to turn the conference over to Christian Arnell. Please go ahead.

Christian Arnell: Thank you. Hello, everyone, and thank you for joining us today. Our earnings release was distributed earlier today and is available on the IR website at ir.cootek.com, as well as through PRNewswire.

On the call today from CooTek are Mr. Karl Zhang, Chairman and Chief Architect; and Ms. Jean Liqin Zhang, Chief Financial Officer. Karl will review business operations and company highlights, followed by Jean, who will discuss financials and guidance. They will both be available to answer your questions during the Q&A session that follows.

Before we begin, I'd like to kindly remind everyone that this conference call may contain forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended. These forward-looking statements are made under the safe harbor provisions of the U.S. Private Securities Litigation Reform Act of 1995.

These forward-looking statements can be identified by terminology such as "will," "expect," "anticipate," "future," "intends," "plans," "believes," "estimates," "confident" and similar statements.

Any statements that are not historical facts, including statements about CooTek's beliefs and expectations, are forward-looking statements that involve factors, risks and uncertainties that could cause actual results to differ materially from those in the forward-looking statements.

Further information regarding these and other risks, uncertainties or factors is included in the company's filings with the U.S. Securities and Exchange Commission. All information provided on this call is current as of today, and CooTek does not undertake any obligation to update such information, except as required under applicable law.

It is now my pleasure to introduce Karl. Karl, please go ahead.

Karl Zhang: Thank you. Thank you, everyone, for joining our second quarter earnings call. The quarter delivered mixed results, with both promising progress and growth opportunities as well as a challenge that we have taken very seriously and are addressing as fast and forcefully as we can.

Growth remained strong in the second quarter. The average DAU of our content-rich portfolio apps reached 27.6 million in June. Thanks to the continuous investments in our content ecosystem and the optimization of products and operations such as the user recall program, the engagement rate of our portfolio apps continued to grow to 42% in June of this year, up from 39% in March this year, 37% in December, and 33% in September last year.

We have been consistently making significant progress by releasing competitive products, retaining our users and actively facilitating interactions with our products.

Our mission is to empower everyone to enjoy relevant content seamlessly. We believe that the global content app market is still in its early stages, and this gives us massive opportunities in both horizontal and vertical areas. We are investing to firmly establish and continuously evolve our content ecosystem in order to achieve long-term competitiveness and user stickiness.

For example, Cherry, our female healthcare and lifestyle community app, has reached a second-month user retention rate of nearly 60% as we continue to evolve our content ecosystem. All along, we've continued to incubate new content apps to expand our reach across a wide and diverse array of user interests.

Our sophisticated growth platform is built by leveraging our unique in-depth user insights. Starting late last year, we began expanding our product offerings for the Chinese market, which showed great potential for us in the first half of this year. TouchPal Phonebook is a content-rich app that we released in the Chinese market, which integrates multiple content formats, such as news feeds and short videos. TouchPal Phonebook's online version regained growth momentum this quarter. This shows just how much growth potential there is for us to expand into and demonstrates our strong execution capabilities to benefit from these opportunities.

On July 17, we were made aware that some of our global portfolio apps had been disabled by Google from the Google Play store and Google AdMob. We reacted immediately and have been in continuous communication with Google to clarify potential misunderstandings behind their actions.

Back in early May this year, we started to receive warnings from Google Play. After discussion with Google, we got clarification that it was related to some ad defects in one of our monetization SDK. We immediately took action to fix the defects and to submit updated versions to Google Play for validation.

Starting from May 24, we received multiple successful approvals and compliance confirmations from Google Play policy. However, on July 17, we received the accounts disable notice. After careful investigation, we believe we fixed the ad defects on a timely basis and got confirmation from Google and that the disable notice might be the result of some misunderstandings.

It appears that one of our developer teams reused some obsolete code in the old SDK for new product features in June. The features are not related to ad activity. We confirmed there was no regression on any of the ad defects, but the code we reintroduced may have created a misunderstanding with Google that we were reintroducing ad defects which we had already fixed.

Our revenue of the second quarter was 37.6 million and was negatively impacted by the difficulties that we are experiencing in collecting our considerations from Google and, therefore, our inability to recognize the corresponding advertising revenues for the last two months of the second quarter as a result of Google's decision.

The sequential increase in G&A expenses for the second quarter was mainly due to an increase of $4.7 million in bad debt provisions, the majority of which was accrued for certain customers, such as Smaato and Flurry, who were impacted by Google's decision. We believe that the impact from the bad debt will be a one-off and will primarily be reflected in our second quarter financial results.

The current suspensions and the removal of our global portfolio apps could impact our user growth, as approximately 53% of our new users of our global portfolio apps were acquired through Google Play in the second quarter. However, this number was down from approximately 87% in the first quarter of this year.

As mentioned earlier, we are in continuous communication with Google to clarify any potential misunderstandings. However, the process for appealing such suspensions and the removals could be time-consuming, and we could not guarantee that this appeal will prevail or that any such suspended or removed applications will be made available again. Regardless, we are well prepared for either outcome and have already put in place operational measurements which we can rapidly roll out and will allow us to continue to acquire new users.

Let me emphasize that Google's action does not impact the ability of our existing users to use our apps and generate ad inventory, and we believe that its impact will be short-term. Our sophisticated user growth capabilities leveraging our in-depth user insights remains strong and unique. Our fast-growing CooTek ads platform ensures monetization stability in the mid-term. We are going to release new apps in the global market that we will cross-sell to our existing users.

With that, I will hand the call to our CFO, Jean, to walk you through our financial results for the quarter.

Jean Zhang: Thank you, Karl, and thanks, everyone, for joining us on the call today. I'm going to walk you through our second quarter financial results.

Now, let me start with users. Monthly active users for our portfolio products reached 65 million in June, up 192 times from a year ago. Average daily active users for our portfolio products in June reached about 28 million, up 2.8 times compared to last year. Average daily active users on TouchPal Smart Input in June were approximately 144 million, up 15% from last year, and MAUs were up 11% compared to last year.

The total revenue was $37.6 million, up 33%, and includes ads revenue of $36.7 million, also up about 33%. Within total advertising revenue for the second quarter of 2019, portfolio products contributed approximately 78%. TouchPal Smart Input contributed approximately 6%, and the TouchPal Phonebook contributed about 16%.

Turning now to expenses, our quarter two GAAP costs and expenses were nearly $52 million, an increase of 31% sequentially and 98% from the same period last year. Non-GAAP costs and expenses were nearly $51 million, an increase of 31% sequentially and 98% year-over-year. As a percentage of revenue, non-GAAP costs and expenses accounted for 135%.

We delivered strong revenue growth year-over-year. The total revenue was US$40 million, up 83%, and the ads revenue was US$39.4 million, up about 89%.

We estimate that of the total advertising revenue for the first quarter of 2019, portfolio products contributed approximately 75%; TouchPal Smart Input contributed approximately 18%; and the TouchPal Phonebook contributed approximately 7%.

Turning now to expenses, our Q1 GAAP cost and expenses were nearly US$40 million, an increase of 94% from last year, representing 99% of revenue.

Non-GAAP cost and expenses were US$38.7 million, an increase of about 91% year-over-year, representing approximately 97% of revenue.

We were quite effective in growing our user base with portfolio products DAU growth of more than 4 times -- growth of about 4 times year-over-year, and of 36.7% sequentially with S&M expenses up 1.6 times year-over-year and a decrease of 14% sequentially.

Portfolio products DAU grew 2.8 times from the same period last year and 19.5% sequentially. Sales and marketing expenses increased about 1.1 times from the same period last year and 19% sequentially. So our effectiveness of our user base is still effective.

R&D expenses increased by 16% sequentially and 70% year-over-year, primarily due to increased compensation for R&D staff. We ended the quarter with 588 full-time employees, up 62% from last year and 13% from last quarter. R&D employees represented 63% of total employees, compared to 63% last quarter and 62% during the same period last year.

G&A expenses increased by 232% sequentially and 241% year-over-year. The increase is mainly due to an increase of about $4.7 million in bad debt provisions, the majority of which was accrued for certain customers impacted by Google's decision to disable some of our global portfolio product applications.

Our gross margin was 89.4%, up from 86.5% during the same period last year and slightly down from 91.2% last quarter. We had GAAP net loss of $14.1 million, representing 37.6% of net loss margin. Excluding the effect of stock compensation, our adjusted net loss was approximately $13 million, representing a 34.4% non-GAAP net loss margin.

As of June 30, 2019, cash and cash equivalents and restricted cash were $62.8 million, compared to $77.3 million as of March 31, 2019. Under the share repurchase program announced on November 26, 2018, the company used an aggregate of $10 million to purchase 1.1 million ADS as of June 30, 2019.

Turning now to the revenue outlook, we expect total revenue in the third quarter of 2019 to be about $30 million, representing an 18% decrease year-over-year. And for the whole fiscal year of 2019, we expect the total revenue is about $145 million, representing an 8% increase year-over-year. These estimates reflect the company's current and preliminary view, which is subject to change.

Operator, we are now ready to take questions.

Questions and Answers

Operator: (Operator Instructions) Tina Long, Credit Suisse.

Ivy Ji: This is Ivy on behalf of Tina. So given the incident with Google Play, could management shed more color on the user acquisition plan through other channels to boost the user growth? So any new apps in the development pipeline? And what does the user growth target look like for other channels looking into the second half of 2019 as well as 2020?

Karl Zhang: Thank you, and I'm going to answer these questions. So I think the current suspensions and the removals of the company's global portfolio apps could impact our user growth, as approximately 53% of the new users of our global portfolio apps were acquired through Google Play in the second quarter. But this number was approximately 87% in the first quarter of this year and actually 98% in the fourth quarter of last year. So that is in the second quarter, 47% of our new users were acquired from channels other than Google Play, such as Apple's app store, OEM built-in stores and other independent stores.

The overall unit costs and the economics are relatively at the same level with Google Play. So by increasing the user acquisition budget on those channels, we will effectively mitigate the risk of user growth.

And at the same time, we have been in continuous communication with Google to clarify any potential misunderstandings and to restore access to its global portfolio of apps, though no specific timeline has been confirmed. Regardless, we are well prepared for either outcome and have already put in place operational measurements which we can rapidly roll out and will allow us to continue to acquire new users. And so the management team expects that the growth of our DAU will continue in this year, at least in the fourth quarter of this year. Thank you.

Operator: Hans Chung, KeyBanc.

Hans Chung: So regarding the guidance, does the guidance reflect the worst case, assuming that there's not any revenue from Google, perhaps? And then, also, what if the appealing result doesn't go well and, say, Google denies the appealing? What are other alternative options for us to grow in the future, I mean, in addition to the other channels for customer acquisition? But any other major you can implement? And then following that, what's our current outlook for next year?

Karl Zhang: Thanks, Hans. I'm going to answer these questions. So, yes, we are in a process for appealing the suspensions and the removals of our apps with Google. Actually, there are three following impacts on the current suspensions and the removals of the company's global portfolio apps. So, first, it's had adverse impact on our short-term financial results, especially the second and third quarters.

So our projection -- our guidance for the coming third quarter is pretty conservative, and our second quarter financial results reflected such impacts already, and we used it to project our second quarter revenue to be between $45 million to $50 million. The company was experiencing in collecting its consideration from Google and, therefore, inability to recognize the corresponding advertising revenue for the last two months of the quarter.

And the sequential increase on the G&A expenses was mainly due to an increase of $4.7 million in bad debt provisions, the majority of which was accrued for certain customers, for instance. And so the management regards that such influence on bad debt is one-off and mainly impacting our second quarter financial results.

And here I want to emphasize that Google's action does not impact our existing users to use our apps and generate app inventory, but the certain disability of Google's AdMob account and certain customers' accounts influence made it difficult to effectively fill the inventory in the short term, so this results in decreased ad fill rates, eCPM and RPU, accordingly. However, we believe that such impacts could be offset in the short term by growing our in-house ad serving platform, which is CooTek's ad platform.

As I mentioned in the previous earnings call, that CooTek's ad platform filling the ad inventory directly to advertisers was our strategic choice to optimize our revenue concentration and stabilize our monetization for the long term. So global -- Google contributed approximately 55% to 60% of our total revenue last year, and it narrows down significantly to approximately 25% in the second quarter without considering Google's actions.

Meanwhile, the revenue contribution of our CooTek ad platform consistently increased to over 25%, so we are very confident that our other monetization channels, especially CooTek's ad platform, will result in even better monetization efficiency.

And secondly, the current suspensions of and removals of the company's global portfolio apps could impact our DAU growth, as approximately 53% of the new users were acquired through Google Play in the second quarter. So this number was approximately 87% in the first quarter of this year. But by increasing the user acquisition budget on the distribution channels other than Google Play, we will effectively mitigate the risk of user growth.

And our sophisticated user growth platform and the backbone in that user insight work for any distribution channel, so the user acquisition unit costs and economics will keep the same level with Google Play. This has been validated in the second quarter, given other distribution channels contributed approximately 47% of new users.

So to summarize, Google's actions impact our short-term revenue and user growth, especially the second quarter and the third quarter. The fourth quarter, we are confident to digest most of the negative impacts and to regain growth momentum for both revenue and user growth. And looking forward, our business will even become more stable and sustainable after these (inaudible).

Operator: Vicky Wei, Citi.

Vicky Wei: I have follow-up questions for the second half of 2019. So because of the Google impact, what does management expect about the operating expense in the second half? And, also, what is the RPU trend going into the second half of 2019?

Karl Zhang: Sorry, can you repeat the questions?

Vicky Wei: Yes. So I have follow-up questions about the second half of 2019. So the first one is due to the Google impact, what does management expect the impact to the operating expense profile? And my second question is what is the RPU trend of CooTek going into the second half of this year?

Karl Zhang: Okay, let me answer these questions. So first is about the RPU of our apps, especially the portfolio products. Management expects that the RPU will remain -- the RPU of our portfolio apps for the third quarter will remain the same with the second quarter, and in the fourth quarter, we will regain the growth momentum of the RPU for our portfolio apps. And we expect that we will recover from the impact that Google's position made on the revenue and especially the RPU.

In terms of the operational expense, basically, because we are very confident on the growth momentum and our core competencies, we will basically continue to invest to acquire new users. But at the same time, we will get back more to develop our CooTek ad platform so that we can pick up the RPU very soon. So that is the current plan. Thank you.

Operator: (Operator Instructions) And ladies and gentlemen, this concludes our question-and-answer session. I'd like to turn the conference back over to Christian Arnell for any closing remarks.

Christian Arnell: Thank you, everyone, for joining our call today. If you have any questions or comments, please don't hesitate to reach out to us. This concludes the call. Goodnight.

Operator: Thank you, sir. Today's conference has now concluded, and we thank you all for attending today's presentation. You may now disconnect your lines, and have a wonderful day.