RLX Technology Inc.
Q4 & FY2023 Earnings Conference Call
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Executives
Sam Tsang, Head of Capital Markets
Chao Lu, Chief Financial Officer

Analysts
Peihang Lv, CICC
Lydia Ling, Citi
Eileen Lin, China Renaissance

Presentation

Operator: Hello, ladies and gentlemen. Thank you for standing by for RLX Technology Inc.'s Fourth Quarter and Full Year 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 Incorporation's fourth quarter and full year 2023 earnings conference call. The company's financial and operational results were released through PR Newswire 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 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 our CFO, Mr. Chao Lu. Please go ahead.

Chao Lu: Thank you, Sam. And thanks, everyone, for making time to join our earnings conference call today. 2023 was a transformative year for RLX. Despite external challenges, our outstanding product portfolio and strong strategic execution propelled an impressive recovery throughout the year, setting the stage for new ventures. I will begin with an update on our domestic operations before delving into our international endeavors, followed by a review of our financial performance.

For our domestic business, 2023 was the first full year under the e-vapor industry's new regulatory framework in mainland China. The regulations necessitate prior approval for e-vapor products, restrict flavors to tobacco only, and impose a 36% excise tax on sales to distributors. As a compliant player, we have strictly adhered to the new rules since day one, continuously innovating to offer premium, compliant products amid competition from unauthorized flavored products. Leveraging our strong R&D capabilities and deep industry insights, we more than doubled our selection of approved cartridges this year, from 15 in January to 32 by December.

Additionally, we broadened our cartridge series to four compared with three one year ago, enhancing our offerings to meet the diverse needs of adult smokers with more value-driven options. With a growing product portfolio, we believe we are well-positioned to seize opportunities in China's legal e-vapor market, especially once enforcement against illicit products becomes more effective.

While we have made meaningful progress in 2023, the adverse impact of illegal products is still lingering. Given the broad availability of popular flavors through unauthorized products, their sales still account for a significant portion of domestic sales volume, weighing heavily on compliant products' sales. Unauthorized products are also often cheaper than compliant products, as their manufacturers typically don't pay excise tax and duties. More importantly, they are manufactured without oversight and marketed irresponsibly, resulting in quality control issues that could potentially harm users. This damages the reputation of the entire e-vapor industry.

E-vapor products are meant to reduce harm, not cause or increase it. As our industry offers one of the few smoking harm-reduction options available, effective regulation enforcement is critical in ensuring users' safety and essential to the e-vapor industry's development. We will continue actively working with regulatory authorities, advocating for a responsible and well-regulated e-vapor industry. Meanwhile, we will remain focused on what we can control: that is meeting users' harm-reduction needs with a diverse and growing portfolio of high-quality, compliant products.

That leads me to our overseas business. We believe that adult smokers seeking smokeless alternatives is a global trend. As such, we terminated our non-compete agreement with Relx Inc. in November 2023, enabling our company to explore prospects outside China, where the demand for e-vapor as a convenient and healthier smoking alternative is growing. With mounting evidence from reputable sources like the UK's National Health Service, highlighting vapor's lower health risks compared to traditional smoking, more countries are recognizing e-vapor's role in tobacco harm reduction.

According to NHS, burning cigarettes releases thousands of different chemicals, of which many are poisonous and carcinogenic. Most harmful chemicals, including tar and carbon monoxide, are not contained in vape aerosol. Switching completely from smoking to vaping significantly reduces exposure to toxins associated with risks of cancer, lung disease, heart disease, and stroke.

RLX, with our track record of regulatory compliance and product excellence, is ideally positioned to leverage these global shifts. That's another reason we believe it's the right time for us to expand outside China.

Strategically, our first step is to increase our product accessibility in international markets. We are working with partners around the globe to bring our harm-reduction products to more users worldwide responsibly. Increased access to our quality products will build brand recognition among global adult smokers, driving progress in our expansion efforts. Second, leveraging our extensive industry resources and expertise, we will target key markets and product categories with high growth potential. This, in turn, will boost profitability as margins will expand with scale.

Our recent expansion into Southeast and North Asia has shown promising progress, validating our approach of combining our industry expertise with local insights to refine our market strategies. As we do for our domestic business, we will respond quickly to changing consumer preferences, tailor our product portfolio to fit local needs and help local teams improve operating efficiency.

Going forward, we will continue to expand our business across new markets based on careful evaluation, while developing innovative, premium products to meet global users' evolving needs.

Before I move on to our financial performance, I'm pleased to share that our ESG efforts continued to win recognition from leading global ESG rating agencies. We received an A rating from MSCI for the second consecutive year for our outstanding performance in responsible marketing, commercial ethics, and product security.

In addition, our company's score in the 2023 S&P Global Corporate Sustainability Assessment improved by 13%. Our commitment to integrating ESG best practices remains unwavering, reflecting our dedication to social responsibility and value creation for all stakeholders.

Now, an overview of our operational and financial results for the fourth quarter and full year of 2023. Please note that unless otherwise stated, all the financials we present today are in RMB terms.

In 2023, we strategically adjusted our business model to align with China's new regulatory requirements, focusing on efficiency and profitability. These adjustments have resulted in steady financial improvements throughout the year.

First on Top Line, on a full year basis, our net revenues were 1.59 billion, a significant year-over-year decrease as 2023 was the first full year of the new regulatory era. Our domestic business's recovery pace was uneven. Illicit products resurged quickly after the regulator's special actions ended in April 2023, impacting our sales. We quickly adjusted our strategy and operations in response to the changing market dynamics and further diversified our product portfolio to meet more adult smokers' needs.

For example, we launched Leili, a line of cost-effective products to target price-sensitive users. I'm pleased to report that these efforts paid off. The year-over-year decline in our quarterly net revenues narrowed from 89% for the first quarter to 83% in the second quarter to just 52% for the third quarter.

For the fourth quarter of 2023, our net revenues were up 53.1% year-over-year to 520 million, marking our first quarter of positive year-over-year growth after 7 consecutive quarters of decline. The increase was mainly driven by our international expansion, which began with Southeast and North Asia. Such encouraging results in a short timeframe validate our decision to diversify our revenues geographically.

As I mentioned earlier, we believe adult smokers seeking smokeless alternatives is a long-term global trend. With our deep industry know-how and outstanding leadership team, we are confident that RLX will quickly win the trust and loyalty of adult smokers worldwide.

Next, our gross profit margin. Our full-year gross margin fell 18.8 percentage points to 24.4%, primarily due to the 36% excise tax implemented in mainland China in November 2022. However, thanks to our efforts to optimize supply chain efficiency, improve product designs, and increase the utilization of our exclusive manufacturing plant, gross profit margins for our core domestic business improved quarter-over-quarter throughout the year.

Our fourth quarter gross margin remained stable quarter-over-quarter at 23.7%, as an unfavorable change in revenue mix offset the margin improvement we achieved for our domestic business.

In 2023, we recorded an operating loss of 497 million. Excluding the impact of stock-based compensation, our non-GAAP operating loss was 134 million. Since the introduction of the new regulatory framework, we have been actively adjusting and streamlining our business for greater agility. These efforts are bearing fruit, with stringent cost control driving a 49% decrease in full-year total salaries and welfare benefits, and a 48% decrease in non-salaries and welfare benefits year-over-year.

For the fourth quarter, we recorded our first positive non-GAAP operating profit of 76 million after 3 consecutive quarters of operating loss, thanks to our cost reduction initiatives and positive profit contribution from outside China. This significant turnaround, from an operating loss of 133 million in the first quarter to an operating profit of 76 million this quarter, reflects our robust rebound and growth trajectory.

Moving forward, we will remain focused on optimizing operating efficiency and profitability, as we pursue high-quality growth domestically and abroad.

Our balance sheet remains solid. As of December 31, 2023, the company had cash and cash equivalents, restricted cash, short-term bank deposits, net, short-term investments, long-term bank deposits, net, and long-term investment securities, net of 15 billion. Also, we recorded an operating cash inflow of 305 million in the fourth quarter of 2023, primarily due to improved working capital and inventory management.

Supported by our financial strength and solid balance sheet, we extended our commitment to enhancing shareholder returns. In 2023, we returned value to our shareholders through a total of approximately US$112 million in share repurchases and cash dividends, comprising US$98.5 million from our share repurchase program and US$13 million from cash dividend payout.

As of December 31, 2023, the company had repurchased about US$195.5 million of its ordinary shares represented by ADSs. Our board of directors has authorized the extension of its existing share repurchase program, established in December 2021, for an additional 24-month period through December 31, 2025. The extended program demonstrates our confidence in the company's long-term prospects.

In conclusion, we are proud of our pivotal progress during the past year's challenges. Thanks to our excellent execution and effective strategies, as well as our team's dedication and our partners' deep trust and support, our business remains resilient and strong. Our commitment to meeting adult smokers' needs with premium harm-reduction products and advocating for a responsible and well-regulated e-vapor industry will never waver.

Heading into 2024, we will continue to propel recovery in our domestic business through product innovation, while tapping into new markets abroad to unleash growth potential. We believe our strong financial foundation and solid balance sheet will empower us to seize development opportunities that create value for all of our stakeholders.

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

Questions and Answers

Operator: We will now begin the question-and-answer session. (Operator Instructions). The first question comes from Peihang Lyu with CICC.

Peihang Lv: This is Peihang from CICC. I have two questions here. The first one is regarding your overseas disposable products, WAKA, which have sold very well. And how do you view the growth trend of disposable products overseas, given the intensifying competition and changing regulations in some countries?

And my second question is that in the domestic market, has there been an enhancement in the enforcement? And has the approval process for new products accelerated compared to the past? Those are my questions.

Sam Tsang: Thank you very much, Peihang. So in the last 10 years, the subcategory of e-vapor has evolved from time to time from open system to closed system, from pod system to disposable. One thing that hasn't changed is the overall penetration of e-vapor has been growing among adult smokers. The evolving regulatory landscape and intensified competition presents challenges and opportunities in specific markets, such as proposed ban on disposable vaping products in countries like the UK and France.

For markets that may have banned disposable products, this won't affect the overall demand of e-vapor category over a longer timeframe. Users can move from one product subcategory to another. And we are a global leader in the pod system and have a significant presence in disposable products.

Suppose the ban on disposable products is effective in some markets; in that case, we will encourage users using disposables to use our pod products, as we can provide a similar or even better user experience. For countries that have yet to announce regulatory changes, we will continue to offer and launch various products in various forms, including disposables, pod systems, and e-vapor solutions that may fit different user groups to capture the growth of the overall category.

And regarding your second question about the domestic market, enforcement as well as the product approval, regulators have been continuously cracking down on illegal sales of flavored e-vapor products. And we have long assisted and supported their enforcement. Multiple enforcement actions have been recently carried out nationwide among manufacturers and distributors.

One example is Zhejiang province, where regulators have been working with the police force. They have arrested 23 suspects, closed 7 warehouses, and 1 production facility, and seized illegal e-vapor products valued at RMB15 million. We continue to assist regulators in cracking down on illicit sales of e-vapor products.

We have continuously applied for new approvals for cartridges and devices, as new products must undergo several rounds of reviews to ensure they meet the national standard requirements, including the packaging inspection and technical review of quality and ingredients. Obtaining approvals take time, especially since the Chinese New Year holiday just passed a few weeks ago. We can bring you more exciting new products soon once approved. Thank you for your question.

Peihang Lv: That's very comprehensive, thank you.

Operator: (Operator Instructions). Lydia Ling with Citi.

Lydia Ling: So I have two questions related to the overseas expansion. And the first one is like the overseas expansion, like kick-off the first quarter last year. And so looking into this year and also beyond, so can you actually detail like more of your like overseas expansion plan? And such as which countries and also regions that you plan to expand for this year, and also any other acquisition plan looking forward?

And the second question is on the profitability of your overseas business. And so could you share like a little bit more color on like how is the profitability of your existing overseas business you entered, and also how to further drive the profitability looking forward? And so what kind of the normalized margins that you would target looking forward for overseas business versus like the domestic business?

Sam Tsang: Thank you very much, Lydia. So regarding the international expansion, our two strategic priorities is to increase our product accessibility and enhance our profitability in international markets. So we periodically examine different markets and decide whether to expand to that market. We expanded to North and Southeast Asia in late 2023 and plan to expand to more Asian markets in 2024.

We are confident in many Asian markets and have built a strong presence. We have been and will expand to more markets, and we hope Asian markets can contribute significantly to our company in 2024. For European markets, we are still evaluating the operating, the regulatory changes in certain markets, and it will take some time for us to expand and decide.

Regarding acquisition plans, we do have discussions with potential partners occasionally. We will share more details once we have any meaningful progress.

And regarding the profitability of our overseas business, it is still in the early stages of development, and we have been expanding to certain markets. And the profitability of each market depends on the volume, the competitive landscape, taxation, and pricing across the value chain. Expanding to a new market could change our overall profitability. Even as we are in the process of expanding, the profitability varies across different time periods. Our strategic focus is to optimize product portfolios and expand international sales channels, which could contribute to our top and bottom lines.

Looking at our non-GAAP operating profit this quarter, our efforts to optimize domestic operations' operating efficiency and generate additional earnings from our international franchise have benefited us. As we are still expanding to many international markets, it is premature to share specific margin targets. However, our directional-wise sales volume, which could have economies of scale, is the most crucial factor for profitability. Thank you for your question.

Lydia Ling: Thank you.

Operator: Eileen Lin with China Renaissance.

Eileen Lin: I have two questions. The first one is on domestic market. Can management share some comments on the momentum of domestic sales by month? Is there any changes in the trend? In particular, I also want to get the sense of where are non-GB products now, and what's the latest sense onto this product from the regulator's perspective?

My second question is on the overseas market. UK government recently made some changes in the policies on the e-cigarettes, including restrictions on some disposable and flavored products, and there's a new potential tax on e-cigarettes starting 2026. Have you seen any changes in the market after this announcement, and how do you think it might impact RELX?

Sam Tsang: Thank you very much, Eileen. So regarding our domestic business, the sales trend in the domestic market are influenced by seasonality, with stable monthly averages observed over longer periods. For instance, in February this year, the Chinese New Year holiday lasted for 8 days, with minimal sales a few days before and after the holiday. We also had relatively strong sales in January before the CNY.

We remain vigilant in monitoring the illicit markets and assist regulators in combating these challenges. Our commitment to compliance and market integrity supports regulatory efforts to secure consumption tax, and can position us as leaders in promoting responsible market practices. Our proactive stance on compliance and collaboration with authorities will foster a healthier market environment and support sustainable growth.

So regarding your second question about the recent proposed policy in the UK, I think the UK regulatory changes could present a nuanced landscape, opportunities to adapt and capture new consumer segments. We can share our view on these three topics that you mentioned. First is the proposed disposable ban. As you have mentioned, the prohibition of disposables will not -- as we have mentioned earlier, the prohibition of disposables will not change the overall demand in the long run, as most users who migrate from disposables to other forms back to the pod system.

There have been early signs that some distributors and retailers have started encouraging users to convert from disposables to the pod system, which allows us to expand to the market and acquire new users in the medium term. The ban may create short-term chaos in the market, just like what happened in the U.S. and China, but we are well prepared for the changes.

Second, regarding proposed vapor restrictions, British regulators have been encouraging adult smokers to switch from cigarettes to reduced-risk products like e-vapors. Regulators are concerned about appealing packaging, use appealing flavor, and advertising. But at the same time, they also understand flavor's role in adult smokers' transition. In other words, products with plain flavors and packaging that are not marketed and appealing to minors shall not be restricted. We are confident that such restrictions should be reasonable and might have minimal impact on adult smokers.

Finally, excise tax could level the playing field. We have seen this introduced in many countries and regions, including the countries where we are currently operating. The current suggested tax rate is moderate compared to other countries globally. This would foster a healthier industry ecosystem, and provide incremental incentives for regulators to combat illegal products. Thank you for your question.

Eileen Lin: Very clear, thank you.

Operator: At this time, there are no further questions. 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 Investor Relations team through the contact information provided on our website, or Piacente Financial Communications. Thank you.

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