

Huami Corporation (HMI) Second Quarter 2020 Earnings Call

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Company Participants

Brad Samson	VP, Investor Relations
Grace Zhang	Investor Relations East
Wang Huang	Chairman and CEO
David Cui	CFO
Mike Yeung	COO

Operator

Hello ladies and gentlemen. Thank you for standing by for Huami Corporation's second quarter 2020 earnings conference call. At this time, all participants are in listen-only mode. Today's conference call is being recorded. I will now turn the call over to your host, Ms. Grace Zhang, Director of Investor Relations for the Company. Please go ahead, Grace.

Grace Zhang

Hello, everyone, and welcome to Huami Corporation's second quarter 2020 earnings conference call. The Company's financial and operating results were issued in a press release via newswire services earlier today and are posted online. You can also view the earnings press release and the slides to which we will refer on this call by visiting the IR section of the Company's website at www.huami.com/investor.

Participating in today's call are Mr. Wang Huang, our Chairman of the Board of Directors and Chief Executive Officer, and Mr. David Cui, our Chief Financial Officer. The Company's management will begin with prepared remarks, and the call will conclude with a Q&A session. Mr. Mike Yeung, our Chief Operating Officer, will join us for the Q&A session.

Before we continue, please note that today's discussion will contain forward-looking statements made under the safe harbor provision of the U.S. Private Securities Litigation Reform Act of 1995. Forward-looking statements involve inherent risks and uncertainties. As such, the Company's actual results may be materially different from the views expressed today. Further information regarding this and other risks and uncertainties is included in the Company's Annual Report on Form 20-F for the fiscal year ended December 31, 2019, and other filings as filed with the U.S. Securities and Exchange Commission. The Company does not assume any obligation to update any forward-looking statements except as required under applicable law.

Please also note that Huami's earnings press release and this conference call include discussions of unaudited GAAP financial information as well as unaudited non-GAAP financial measures. Huami's press release contains a reconciliation of the unaudited non-GAAP measures to the unaudited most directly comparable GAAP measures.

I will now turn the call over to our CEO, Mr. Wang Huang. Please go ahead.

Wang Huang

Hello, everyone. Thank you for joining our earnings conference call today. I want to start by highlighting four key takeaways from the quarter's financial and operating performance.

First, it wasn't a typical quarter for the industry. We delivered good revenue growth in the second quarter and first half, at or near the top of industry growth.

Second, we are well positioned with our latest new products and others yet to come as we go into the full run-up to the year-end holidays.

Third, the consistent investment in R&D should continue our active development, pace and innovation into 2021.

Fourth, recent insurer wins for our analytics offerings, partnerships such as the one announced yesterday with Aspen Imaging Healthcare, and progress with our university research partners, give me confidence in the future for the institutional side of the business.

Despite global disruptions caused by the COVID-19 pandemic, we delivered good growth on both revenue and product shipments. In particular, our Amazfit-brand smartwatch shipments grew 30% year-over-year in the second quarter.

This result bears witness to our strong value proposition, recognition of our own Amazfit brand and expanding sales and marketing strategy.

Another achievement in the second quarter was that we successfully shipped Xiaomi's Mi-Band 5, the fifth generation in the popular product line.

I hope everyone saw today's launch of our new Zepp brand, which is our healthcare services brand. Today, we are kicking off with a premium tier of smart devices, beginning with two new smartwatches. We are reintroducing the Zepp brand, which we acquired in 2018, with a broader smart ecosystem vision.

As part of this, we are rebranding the consumer phone app to Zepp, as well, in the U.S. The first of the new Zepp models, the E, will be available in the next week on Zeep.com and on Amazon.

These new products are part of our continuous execution on our mission to 'Connect Health With Technology.' In order to build a comprehensive health and fitness ecosystem, strong capabilities in hardware, big data analytics, algorithms and product certifications are all indispensable. To tackle these, many companies choose to find solutions from outside suppliers. We chose a road few took, developing the solutions ourselves. I firmly believe one cannot excel in software without expertise in hardware, and vice versa, and people who are really serious about big data, should make their own sensors. We develop not only smart devices, but also AI chips, sensors, healthcare related data and algorithms and now have a comprehensive AI-driven health management platform.

During our first AI innovation convention in June, we launched RealBeat 2 an upgraded cardiac health monitoring algorithm, which significantly improved the effective detection of atrial fibrillation at night and during the day by 87% and 564%, respectively, compared to his pet defense assessor. We also launched OxygenBeat, which enables near medical grade blood oxygen level measurement for our smart devices. Furthermore, in the second quarter, we launched the new generation, our bio-sensor, BioTracker2, as well as completed the design phase for our self-developed AI chip, Huangshan-2. Huangshan-2 has more processing capability than its predecessor and enables more healthcare related functionalities that will further differentiate our future smartwatch products. We plan to start volume production of Huangshan-2 in the fourth quarter of this year, and by the first half of 2021 making it available to our users through our smartwatches.

In July, our wholly owned subsidiary PAI Health, announced an agreement with Prudential Corporation Asia to incorporate PAI Health's science-backed activity metric into Prudential's digital health app, Pulse. Later this week, we will be announcing a follow-on expansion of our relationship with Prudential, to co-develop new consumer solutions that may be made available to their users, as well as Huami's.

As you know, Huami's connecting health with technology' strategy is broad. While we have already achieved significant market strength on the consumer side of health technology, we have a nascent industrial side of the business. Focusing on the insurance and medical institutional side of the industry can help us make devices smaller, portable, less expensive, and allow us and care providers to aggregate more medical data for analytics services. PAI Health's recent success is one example.

Yesterday, we announced a new venture with Aspen Imaging Healthcare, which is pioneering new x-ray technology. We expect to leverage and combine the engineering expertise of both

companies in cooperative product development. We expect to leverage our broader international distribution capabilities for Aspen. And we will explore potential investment in the company. Aspen, which is based in Plano, Texas, is creating some disruptive technology for medical imaging, which can open or expand new applications.

Additionally, we are very pleased to have partnered with internationally renowned respiratory expert and a fellow of Chinese Academy of Engineering, Dr. Zhong Nanshan to establish research laboratory facilities. The purpose of this lab is for the on-going study of respiratory disease rehabilitation management using wrist wearable devices that leverage our expertise in smart wearable technology, AI algorithms and big data biometric analysis.

While the first half of 2020 was a challenging period for all of us, we are proud of our performance in smart, wearable products shipments, and the strong execution of our health service strategy. We are confident that our device shipment volume will continue to climb in the second half of the year, and we look forward to delivering value to all of our stakeholders.

Thank you again for joining today. I will now turn the call over to our CFO, David Cui.

David Cui

Thank you, Wang. The strength of our brand, products, and global sales and marketing strategies served us well in the second quarter, despite globally uncertain times. The unit sales of both self-branded products and Mi-Band rose to 8.9 million, increasing by 7.2% from the same period last year, and leading to 9.5% revenue growth. I am especially pleased that we remained profitable, despite the lower gross margin affected by our product mix.

Second quarter saw the continued prioritization of investment in R&D, as well as sales and marketing infrastructure, as product development and sales channel expansion remain critical components of revenue growth. While these costs impacted short term profitability, we are confident that continued strategic spend in these areas, coupled with prudent cost control in other general operating expense categories, will lead us to stronger profitability in the long term.

Mindful of the length of this call, I will highlight the key financial measures for the second quarter of 2020, and I encourage you to refer to our earnings press release for further details regarding our financial performance.

Now, here are some of the highlights of our second quarter. All amounts are expressed in RMB unless otherwise stated.

As previously mentioned, revenues in the second quarter of 2020 increased by 9.5% to RMB1.137 billion from RMB1.039 billion for the second quarter of 2019. Unit growth in the quarter was 7.2%, and for the first half of 2020 was 18.7%.

Gross Profit decreased by 8.6% to RMB253.4 million from RMB277.3 million in the second quarter of 2019. Our gross margin was 22.3% compared with 26.7% a year ago. Gross margin can be affected by product mix, as different products have different margin contributions, and this can change over the life of a product. In the second quarter of 2020, total gross margin was positively affected by a higher mix percentage of Huami-branded products, offset by a higher mix of a lower margin product shipped to Xiaomi, and by discount promotions for some older products in the transition to the new Xiaomi Mi-Band 5.

Next, I want to discuss the impacts of COVID-19 on our business. The Coronavirus continued to have a significant negative effect on retail sales in all areas of the world, and in most product categories, through the second quarter. For example, although China recovered and opened many retail establishments midway through the second quarter, a number of Asian retailers reported that shoppers were slow to return, depressing second quarter results. In the Americas and Europe, continued or resurging Covid infection rates kept many stores closed, and also kept many shoppers out of the stores. Many retailers reduced inventories and orders during the second quarter. These all affected our second quarter results.

Production delays due to the pandemic that slowed manufacture of products in the first quarter have been resolved, with minimal lingering impacts in the second quarter.

Looking forward, Huami is working with its channel partners flexibly as they reevaluate or change their market strategies, such as shifting focus to online sales and on-demand retail models. While Huami has several direct online sales channels, the vast majority of our revenue flows through these retail partner channels.

Before the pandemic hit, industry expectations were for strong demand and continued growth for smart health technology for many years. Aside from the disruption and re setting of consumer purchasing method choices, we see no evidence to indicate that megatrend has been materially changed. Whether by personal choice or by encouragement from those who pay for our care, the world is increasingly focused on improving health. In the nearer term, with all the reports of people gaining weight during lockdowns, we think there may be upticks in demand for smart health technology in different geographies as people refocus on their health.

In addition, the company is engaged in research and development related to detection of COVID-19 infection through its internal R&D team, as well as with some of its university research partnerships.

Moving to expenses.

Research and development expenses increased 25% to RMB117.2 million from RMB93.8 million for the second quarter last year. As a percentage of sales, R&D expense only increased 130 basis points to 10.3% in the second quarter.

We are striving for building up a top-tier R&D team for our future growth. The increase was primarily due to an increase in the number of R&D staff, and a rise in investment in healthcare related features, algorithms, cloud services, chip research, and new product development as we carry out our mission. R&D was also up as we are aiming to launch a series of new products in the second half of 2020 to expand our customer base, as we target different geographies and price points.

Our sales and marketing expenses increased by 76.6% to RMB71.3 million from RMB40.4 million for the second quarter last year. On a percent of sales basis, sales and marketing expenses rose to 6.3% of revenue versus 3.9% in the year ago quarter. The increase was primarily due to expanding international markets outside of China for our Amazfit branded products, including increases in advertising and promotional expenses during holiday sales, and promotional events and growth in personnel-related expenses.

In June, we organized our first AI Innovation Convention to present our current research results to the public and open our first Amazfit offline retail store in Beijing to offer domestic consumers the opportunity to have a first-hand in person experience with our products and build our brands. We have a strategy to open a number of these locations globally; a number of these are as independent authorized dealers.

Second quarter 2020 general and administrative expenses increased to 9% to RMB55.4 million from RMB51.0 million for the second quarter last year, reflecting primarily an increase in exchange rate fluctuations, professional fees for business management, and depreciation and amortization expenses, offset by a decrease of share-based compensation.

Total operating expenses increased by 32% to RMB244.0 million from RMB185.2 million for the second quarter of 2019. Total operating expense represented 21.5% of revenue in the second quarter 2020, compared to 17.8% in the year ago quarter, and 20.6% in Q1 2020, reflecting our strategy of consistent investment in R&D with an emphasis on healthcare related product development and testing, talent acquisition, in addition to branding and

marketing to enhance our company's long term returns.

Operating income for the second quarter 2020 was RMB9.4 million, down from RMB92.1 million in the Europe year ago quarter, driven primarily by the year-over-year increase of RMB31 million in sales and marketing expense, and RMB23 million in R&D.

Relating to cash, as of June 30, 2020, the company had cash and cash equivalents of RMB2.6 billion, compared with RMB1.8 billion as of December 31, 2019.

Now, let's turn to our outlook.

For the third quarter of 2020, management currently expects net revenues to be between RMB2.1 billion and RMB2.15 billion, which would represent an increase of approximately 13% to 16% from the third quarter of 2019. That outlook is based on the current market conditions and reflects the company management's current and preliminary estimates of market and operating conditions and consumer demand, which are all subject to change.

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