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CONFERENCE CALL PARTICIPANTS

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Wei Chen *Goldman Sachs - Analyst*

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PRESENTATION

Operator

Welcome, everyone, to HTC's 2016 first-quarter results conference call and webcast in English. Today with us we have CFO and President of Global Sales, Mr. Chialin Chang, and Investor Relations, Miss Kelly Hsu. All lines have been placed on mute to prevent background noise. And after the presentation there will be a question-and-answer session for investors and analysts. Please follow the instructions given at that time if you would like to ask a question.

For your information, this conference call is now being broadcasted live over the Internet. And a webcast replay and English transcript will be available within an hour after the conference is finished. A Chinese translated transcript will be available within a week after the call is finished. Please visit www.htc.com under the Investors section.

And now I would like to introduce Miss Kelly Hsu from Investor Relations. Miss Hsu, you may begin.

Kelly Hsu - *HTC Corp - IR Manager*

Thank you. Good morning, good afternoon and good evening, ladies and gentlemen. Welcome to HTC's 2016 first-quarter analyst call. This is Kelly Hsu, HTC's IR Manager.

The event is now being webcast live via HTC's website at www.htc.com. If you are joining now through the dial-in line, your call is now being placed on mute. As this conference is being broadcast by investors around the world, we will conduct this call in English only.

The format for today's call will be as follows. First, I'll summarize our operations for the first quarter. Afterwards our CFO and President of Global Sales, Mr. Chialin Chang, will lead the Q&A session.

Before we begin, I'd like to draw your attention to the disclaimer statement on page 2 of the presentation slides. Please note that this presentation contains forward-looking statements. These statements are based on our current expectations. Actual results may differ materially from our expectations and the Company undertakes no obligation to update these forward-looking statements going forward.

If there's no question, I will begin to give the overview for the first quarter. Please turn to page 3.

Page 3, first-quarter financial highlights. Revenue for first quarter was TWD14.8b, with gross margin of 9.4%. Operating loss was TWD4.8b and operating margin of negative 32.4%. We have disposal gain of TWD2.1b from the sale of land and building in Taoyuan. And net loss after tax was TWD2.6b or loss per share of TWD3.16.



Business overview. Over the first quarter, HTC gained critical acclaim across its entire portfolio, including the HTC Vive virtual reality system, the UA Healthbox, the HTC One X9 and the new Desire smartphone models.

Looking forward, HTC has seen strong launches in the early second quarter for both the flagship smartphone, the HTC 10, and the HTC Vive virtual reality system and anticipates good momentum over the year. HTC will continue to streamline processes and optimize resources to develop products in the most effective way.

Page 4. Page 4 gives an overview on revenue and operating profit. Revenue for the first quarter came in at TWD14.8b. Operating loss was TWD4.8b.

Page 5. Page 5 gives an overview on gross margin and operating margin. Gross margin for first quarter was 9.4% and operating margin was negative 32.4%.

Page 6 and 7 are financial overviews for income statements and balance sheet.

This wraps up the content of our presentation. And now I'd like to turn the podium to HTC's CFO and President of Global Sales, Mr. Chialin Chang. Moderator, we can start the Q&A session.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Richard Kramer, Arete Research.

Richard Kramer - Arete Research - Analyst

Thanks very much. First one, Chialin, can you talk about the gross margin of 9% and whether there were any specific items there?

And then again, looking at the four quarters of roughly TWD5b or so operating loss, can you talk about the portion which was one-off restructuring cost versus the -- what the underlying profitability of the business is?

And then I have a follow-up on VR. Thanks.

Chialin Chang - HTC Corp - CFO & President of Global Sales

Yes. I think the margin, the 9.4%, that's probably on the low part of what it should be. As you know, this part of the cycle is that you basically run a 12-month cycle the moment you announce the new flagship. As you are aware, we didn't really have a good performance on our flagship last year. So that caused -- that caused that we basically have, I would say, the opposite of the halo effect.

In terms of the operating losses that you're asking how much is actually due to restructuring cost. I think part of it actually is embedded in the operating expenses and we didn't breakdown in there. So I will not talk about it given that we didn't breakdown in there. I would say, however, that the restructuring cost I think will continue on in Q2, probably will end in Q3, as we said last time. So those are the two things I will comment on.

And on your second question on Vive, please go ahead -- on VR.



Richard Kramer - *Arete Research - Analyst*

Yes. I guess the -- what you're describing with the continuing losses suggests that for the moment, or at least for this year, again smartphones will be structurally loss-making. Can you help us understand the economics of the VR business? Is this something that is part of those losses, i.e. you are clearly in development mode and in ramp-up mode? Is this something that you expect to materially impact sales and/or earnings this year, either earnings negative or positive and sales? Could it be a material component that we would recognize it in sales? Just to try to understand your thinking on the scope of this business. Thanks.

Chialin Chang - *HTC Corp - CFO & President of Global Sales*

I think the smartphone business, however, I would say the following. The -- even though we didn't -- we are not going to give a guidance so I probably won't be able to say so much quantitatively. But on the smartphone business, we're seeing the sequential improvement in Q2 versus Q1. And if you ask me today, given the uncertainties, I won't be able to see. But internally, if you ask me today, we also anticipate, we hope probably is the better word, that Q3 will be better than Q2.

And in fact, internally, from the internal management perspective, we are hoping in Q3 on the smartphone business, from the internal cost of revenue [matching] perspective here, we'll be able to achieve breakeven. But this is again not a quantitative guidance. I don't want to trigger the regulatory in terms of providing guidance, but that's our hope internally.

And coming to the VR business, what we're trying to do on VR business here is I think the VR business is going to be a meaningful part of it in terms of revenue contribution and keep up building in that. I think on the VR business, given this is the initial stage of a multi-year growth, we see a huge potential in virtual reality, or the [related] part of it, in the next decade. We are quite [grateful] we think we have differentiated Vive in the very beginning.

So it depends on how, which I would not be able to disclose, it depends on how we're going to put in the investment and resources into it. What I can tell you here is we're going to put in the -- put in material resources, making sure that we will continue the solidified [lead]. So that's something we will compound on the VR part of it.

But I do want to emphasize that actually we've seen the sequential improvement on the smartphone business. We hope we have a good breakeven outcome. That's what we're hoping for Q3 for the smartphone business. As you know, [product and on the channel, we actually just announced the HTC 10 and gaining a good traction. So hopefully this momentum will sustain and continue.

Richard Kramer - *Arete Research - Analyst*

But just the last question on VR, is this something that we -- when we're looking at the depth of these losses, are a portion of them attributable to VR or is this just still overall, both from a revenue and cost perspective, still such a small element of the mix that it's not going to have a huge material impact either way by the end of the year?

Chialin Chang - *HTC Corp - CFO & President of Global Sales*

I won't be able to break down. But I would say the following. When we sell VR, in terms of the product we sell, we're not looking for a loss-making sales for the VR. But we do need to think about how much investment we need to put in in terms to position us and to laying the foundation for the VR business in that regard.

So the eventual possibility will be part of the -- in terms of the revenue and gross profit and the OpEx you want to put in there in terms of growing the business. So it's a combination of those. And I do think the VR part, in the sequential course of this year here, will be a meaningful part in terms of the OpEx side, also in terms of the revenue side as well.



Richard Kramer - *Arete Research - Analyst*

Okay. Thank you very much.

Chialin Chang - *HTC Corp - CFO & President of Global Sales*

Thank you.

Operator

(Operator Instructions). Anne Lee, Nomura.

Anne Lee - *Nomura - Analyst*

Hi. Hello, Chialin. May I ask a question regarding recent news about that VR division has any plan to spin off?

Chialin Chang - *HTC Corp - CFO & President of Global Sales*

Thanks. I think we've heard the -- we actually saw the report. We actually, as requested of stock exchange, we also put in the clarification in there. What I would say is the following. I think this is a -- we think it's a very high-potential market and we're going to put in resource to make sure that we have a long-term success in this sector and this industry. And hopefully that will benefit our shareholders.

So structurally, whatever we do, I think it is very important that the -- at this point that I want to make sure it's clear that whatever we do structurally, we want to make sure that this is in the best interest of our shareholders, for all the shareholders' interest. At this point I won't be able to comment on exactly what we are planning to do because this is still ongoing. There are various ways we're thinking about it.

But the goal is making sure strategically we're successful in the long term. And that in turn will benefit the shareholders in the long term. And also structurally basically is making sure that it's in the best interest of the shareholders. So that's what I will comment today.

Anne Lee - *Nomura - Analyst*

Okay. And my second question is regarding the second-quarter outlook. Maybe you already answered some of these outlook things in the prior questions, but specifically for second quarter, could you give us more color?

Chialin Chang - *HTC Corp - CFO & President of Global Sales*

I think what I would say is the following. Basically the -- given that we're not providing guidance, so I want to be careful in terms of providing points. We're seeing sequential growth in our smartphone business, improvement in our smartphone business. We hope in Q3 actually it's also even better than Q2. But given this couple of month down the way -- down the road, this is all sort of things that could happen.

On Q2, we also want to say that we start shipping out the HTC 10 in April. We think we'll continue to ship more in May. And it depends on how we sell and that will determine the June and also beyond the volume in there. We're actually quite hopeful that the HTC 10 will bring back the momentum and halo effect.

We've started selling it in Taiwan. You guys probably also checked the channel already. We've seen the positive feedback in there and healthy channel sales within the first week or so. So hopefully -- we hope that momentum will continue.

Anne Lee - Nomura - Analyst

How about the VR part for second quarter?

Chialin Chang - HTC Corp - CFO & President of Global Sales

We also start shipping VR in April. The pre-orders are pretty good and healthy. And we continue to make sure we deliver to the hands of people in the shortest time. So we continue to see a good reception on the VR side as well for both pre-order as well as people who just directly purchase it. We also extended beyond online to select the retail outlets in select markets in there. So hopefully that will give us an additional boost in that regard.

Anne Lee - Nomura - Analyst

Okay. And by the way, when will you announce April sales, because usually it will come together with the results?

Chialin Chang - HTC Corp - CFO & President of Global Sales

It'll come out today as well because we just wanted to time it together with the earnings call.

Anne Lee - Nomura - Analyst

Okay. I see. Okay. Thank you. I have no more questions.

Chialin Chang - HTC Corp - CFO & President of Global Sales

Thank you.

Operator

(Operator Instructions). Richard Kramer, Arete Research.

Richard Kramer - Arete Research - Analyst

Thanks. Just two more short ones. First of all, Chialin, well before you arrived at HTC, they obviously had quite a substantial ODM business. And whenever you get to publish your annual report, we're going to see again, I suspect, that production capacity is substantially greater than the production volume of smartphones. Have you considered, especially in the light of the 9% gross margin, a different model for what has to be very poor capacity utilization at present?

And I have one other clarification on what you said on the VR point, but I'll touch on that in a second. Thank you.

Chialin Chang - HTC Corp - CFO & President of Global Sales

Thanks. I actually think the [low] part of the gross margin in Q1 I think has less to do with the manufacturing in terms of the under-capacity. In fact, we actually have come a long way since we consolidated our manufacturing resources in there. There may be some of the equivalent part here that we'll put aside. But in terms of the labor part and also the [venue] actually we consolidated quite well in that regard.



And we basically have prepared in such a way that allows us to expand if we need to. And it allows us to outsource to the ODM or EMS if we need to. So what we intend to do here is the key more-difficult-to-assemble or manufacture part, we do it in-house. Some of the easier ones we actually could potentially just outsource and so make it a -- make sure that the manufacturing value-add for the part that we manufacture in-house is competitive. So that's the current status we have in terms of the manufacturing side here.

Go ahead on the second.

Richard Kramer - Arete Research - Analyst

Okay. And just on VR, just because I -- you made a comment about the OpEx and also revenue in the second half of the year. Have you been accruing all the operating costs of the VR business as they've come in or are some of those being deferred until the first shipment, i.e. would we see increases in R&D and SG&A now that you start to recognize the costs along with the revenue? I just want to understand that. Thanks.

Chialin Chang - HTC Corp - CFO & President of Global Sales

On VR side, I don't recall that we actually accrue costs. I think we just expense it as they occurred. So I don't remember anything we actually accrued. That's just the expenses that occurred.

Richard Kramer - Arete Research - Analyst

Okay. Thank you.

Chialin Chang - HTC Corp - CFO & President of Global Sales

Thanks.

Operator

(Operator Instructions). Wei Chen, Goldman Sachs.

Wei Chen - Goldman Sachs - Analyst

Hi. Hello, Chialin. I have a question on how you're going to balance your cost to revenue. I think for the past few quarters you've been talking about matching those two components and eventually get the smartphone business to breakeven. So just first looking at your first-quarter operating expenses, on a year-on-year basis you are down 24%, which is still less than 35% of your target. That's first, and what's going on there. And moving forward into the second half, particularly the third quarter, what gives you the confidence that your revenue and your expenses will start to match?

Chialin Chang - HTC Corp - CFO & President of Global Sales

Well this is the business you probably won't be able to control your revenue side, but you're able to somewhat control your operating expense in terms of the resources you put in there, the R&D expenses, the sales marketing expenses and the infrastructure expenses in that regard. I think the -- as I said last time here, the operating expense, the -- Richard also asked a question about part of it is actually restructuring expense in that. I think you'll continue to have that.

The trimming, I would say the trimming probably for us will be done in Q2 and then some of our expenses we booked here are going to extend into Q3. I think after Q3, basically that's the expense we won't have for the smartphone part.



On the VR (technical difficulty) we still think about what will be the right optimum given the growth potential in our environment. So what we do on the smartphone side here is, given the expenses, and I can tell you internally we know what the expenses are for the smartphone side, so what we'll do here is to match the revenue for the expense side. That's why I said at the very beginning we hope that in Q3 on smartphone business side will be able to break even.

Wei Chen - *Goldman Sachs - Analyst*

Got it. And besides on looking at revenue and cost, can you give us more color on the smartphone strategy longer term, like what kind of products and segment you want to focus on and how do you think about the SKU reduction, which region that you want to put more emphasis on? On the product strategy side, can you give us more color?

Chialin Chang - *HTC Corp - CFO & President of Global Sales*

I think the -- on the smartphone side, you can see we basically simplified our SKU quite a lot. We also simplify and focus on certain regions which we need to do -- need to focus on. And the -- what we would do on the smartphone side here is the -- we don't want to go to the very, very low end, which we're not really that competitive. So however, there is a segment of positioning actually HTC products, you get this natural -- like pull from the end market perspective here. So that's where we focus on our part.

And you can see on the flagship, when we announced the flagship, the typical country getting this traction would be in the US. In Europe it will be Germany, the UK, France, and then you probably have a traction in the Middle East. And in Asia you have it in Taiwan and Australia, but not the -- in India, high end is not that strong yet so we don't get [this] last year, but these are the typical suspects in that.

And then in various countries you're going to have a difference. So for example, in India you're going to have mid-tier here, which is going to be possible in that regard. But that's what we will do on that segment. We think we're clear on segments in terms of price positioning. We think we're clear in terms of country we want to focus on. So it will come down to how we execute basically.

Wei Chen - *Goldman Sachs - Analyst*

Okay. All right. Thank you very much.

Chialin Chang - *HTC Corp - CFO & President of Global Sales*

Thank you.

Operator

Amy Wong, Daiwa.

Amy Wong - *Daiwa - Analyst*

Chialin, thank you for taking my question. I have two questions regarding the VR. The first question is could you talk a little bit more about what's the margin for the Vive products? Is the scale really reaching a certain scale you expect? Will it similar to smartphone level or do you think it will be -- give you a push for more [series]? So in terms of product gross margin-wise, it may be slightly lower than smartphone space.

Chialin Chang - HTC Corp - CFO & President of Global Sales

I cannot tell you the VR gross margin given that it's pretty competitor-sensitive. So I would probably tell you the -- we have good traction on VR, but I won't be able to disclose too much given the sensitivity.

Amy Wong - Daiwa - Analyst

Okay. That's fine. The second question is in the long term do you see there's a certain point your VR products and the smartphone products actually can have some interaction or even some halo effects to push each sales from each other, or do you think it's more like your VR product will be another unique engine for your Company but the target customer or the sales are actually quite independent?

Chialin Chang - HTC Corp - CFO & President of Global Sales

Actually I don't think they're independent; I think there's overlap in that regard. And we will be, for example, I can give an example in terms of sales that at some of the retail stores our retailers really want to have our VR because that leads to a lot of foot traffic. And that in turn will increase potentially the sales of the smartphone business.

And the VR business and smartphone business, they're also overlapping part of it, for example, as you heard about, should lead to mobile VR opportunity in that. So the -- and also on the business side, in terms of sales side, in terms of product side, they are overlapping in that. And we've been seeing, at least in the VR side, also will help you from a brand perspective, enhance the brand (inaudible) and in turn of the sales and the marketing model.

Amy Wong - Daiwa - Analyst

Okay. Thank you very much. I have no further questions.

Chialin Chang - HTC Corp - CFO & President of Global Sales

Thank you.

Operator

(Operator Instructions). There is currently no question in line. I will pass the call back to the CFO and President of Global Sales, Mr. Chialin Chang, for closing remarks.

Kelly Hsu - HTC Corp - IR Manager

Thanks, everyone, for joining our call. Have a nice day.

Operator

Thank you. Ladies and gentlemen, we thank you for your participation in HTC's conference. There will be a webcast replay within an hour. Please visit www.htc.com under the Investor section. You may now disconnect. Goodbye.

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