

RLX Technology (RLX US)

1Q below consensus; 3Q to be a key quarter for transition

Regulatory headwind and sporadic COVID outbreaks have put RLX's 1Q22 results below market expectation, as a result of a 29% and a 7.7pp decline YoY in revenue and gross margins, respectively. Persistent drags such as 1) provisions made for SKUs (mainly fruit-flavors) that could be impacted by the sales ban starting from Sep 2022, 2) sales mix that gravitated towards lower margins cartridges and 3) penalty to suppliers owing to order cancellation convince us that RLX's margins trajectory likely to be under pressure in the near term. Earnings outlook remains relatively fluid, in our view, considering also the magnitude of sell-through, pricing and sales mix change that could compound and undermine our full-year forecast accuracy. For now, we assume 2Q sales momentum to meaningfully revive to RMB2.2bn (1H22: RMB3.9bn) on the gradual re-opening of Shenzhen retailers and pent-up/ front-loaded demand for flavored cartridges. 3Q will be the key transition quarter when we expect minimal net profit contribution. Depending on new product approval, we are hopeful of seeing sales to pick up sequentially in 4Q. The dynamic near term outlook has put us to refocus on the industry's long term development with a more consolidated competitive landscape and a higher degree of regulatory compliance. We remain Buy-rated.

- **Earnings revision.** We cut 38.4%/ 48.9% of our 2022E/ 23E revenue forecasts to reflect a soft 1Q and hence more realistic sales impact from the new regulation, followed by a 2.6ppt/ 3.4ppt cut in gross margins of the same period, respectively.
- **License application.** RLX has initiated an application in compliance with the licensing requirements under the administrative measures. Approximately 48k licenses will be granted, per management estimate, and that should sufficiently cover the number of applications at the initial stage.
- **Product reformulation.** RLX has developed cartridges and devices that are compliant to the new national standards and has submitted them to the State Tobacco Monopoly Administration for technical review.
- **Valuation.** Following our earnings changes, our revised TP of US\$2.47 is based on an updated 14.0x (from 17.0x) end-22E P/E, which still represents 1sd below the average valuation since March 2021, as we attempt to take into account the perplexed sentiment amid the current tightening on the e-cigar industry. We maintain BUY.

(YE 31 Dec)	FY20A	FY21A	FY22E	FY23E	FY24E
Revenue (RMB mn)	3,820	8,521	5,949	6,425	7,240
YoY growth (%)	146.5	123.1	(30.2)	8.0	12.7
Net income (non-GAAP)	801	2,248	1,601	1,713	1,900
EPS (RMB)	0.6	1.6	1.2	1.3	1.4
YoY growth (%)	n.a	186.1	(25.9)	7.1	10.9
Consensus EPS (RMB)	n.a	n.a.	0.94	1.05	1.72
P/E (x)	n.a	8.0	10.8	10.1	9.1
P/B (x)	n.a	1.3	1.2	1.1	1.0
Div yield (%)	n.a	-	-	-	-
ROE (%)	n.a	15.0	9.2	9.1	9.3
Net gearing (%)	Net cash	Net cash	Net cash	Net cash	Net cash

Source: Company data, Bloomberg, CMBIGM estimates

BUY (Maintain)

Target Price	USD2.47
(Previous TP)	USD4.3)
Up/Downside	+32.1%
Current Price	USD1.87

China Consumer Staples

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Stock Data

Mkt Cap (USD mn)	2,928
Avg 3 mths t/o (USD mn)	34.0
52w High/Low (USD)	11.85/ 1.22
Total Issued Shares (mn)	1,566

Source: Wind

Shareholding Structure

Wang Ying	53.7%
Deep Technology Linkage	9.0%
Fund L.P. and its affiliate	

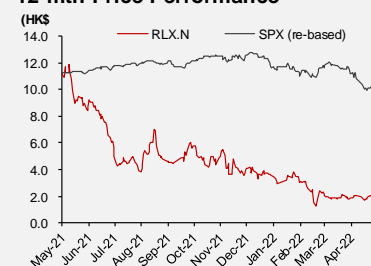
Source: Wind

Share Performance

	Absolute	Relative
1-mth	-7.9%	-2.3%
3-mth	-18.7%	-5.2%
6-mth	-47.5%	-36.2%

Source: Wind

12-mth Price Performance



Source: Wind

Auditor: PricewaterhouseCoopers

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Key takeaways of the earnings call

Key regulatory developments

- The final administrative measures for e-cigarettes have been published in Mar 2022.
- The national standards and a set of detailed regulatory measures on e-cigarettes, licensing, logistics etc were released in the past few weeks.
- The final national standards will come into effect on 1 Oct 2022, granting a transition period until 30 Sep 2022.
- The national standards tighten the R&D and quality control standards for e-vapor products in China, advocating product safety, limiting opportunities for counterfeit, and unauthorized compatible products.
- New regulations will benefit players like RLX, who are capable of adapting to the new framework, while maintaining their scale, as well as their ability to manage user experience and risks effectively and efficiently.
- A regulatory pilot program was launched in April in Huizhou in Guangdong province and Xiamen in Fujian province.
- The new administrative measures were implemented early in these two cities to assess the new e-vapor product supervision process. Selected local retailers began placing orders for e-vapor products with the local subsidiary of China Tobacco, which will distribute e-vapor products in local districts going forward.
- As of now several provinces and cities have locally announced to issue > 48,000 retailer licenses in total in the initial stages of regulatory implementation. Management believes that this number will be adequate to cover the number of applications.

Company's actions in response to regulatory changes

- RLX has already initiated a manufacturing license application in compliance with the licensing requirements under the administrative measures. As the leading industry player, the company believes to satisfy the relevant application requirements.
- The company has already developed e-vapor cartridges and devices that management believes are in compliance with the national standards and submitted them to the State Tobacco Monopoly Administration for technical review. The company believes that its products will pass the review, and be successfully launched to market in due course.
- The company is optimizing operational structure in many aspects, such as warehousing and logistics, ERP systems, etc.

Key 1Q22 business and financial highlights

- A strong recovery in demand from distributors in early Mar.
- Shipment volume in 1Q adversely impacted by the production stoppage at production plant, and delays by some of the suppliers in Shenzhen due to lockdowns.
- Maintained a steady unit cost in 1Q, thanks to continued efforts to optimize supply chain and streamline operations, which the company will continue to do.
- Net revenue at RMB1.7mn, -28.5% YoY, primarily due to lockdowns in Shenzhen.
- GPM at 38.3%, -7.7ppt YoY, primarily due to 1) a change in the product mix, and 2) an expected increase in inventory provision largely due to recent regulatory developments. Excluding costs related to inventory provision, GPM would be at a level similar to that in 4Q21.
- Opex was RMB33.6mn, -97.2% YoY, with selling/ general and admin/ R&D expenses decreased by 73.9%/ 109.3%/ 88.7% YoY respectively, primarily due to the change in share-based compensation expenses, which decreased to a positive RMB325.2mn in 1Q22, from RMB877.5mn in 1Q21, and decrease in salaries and welfare benefits.
- US GAAP net income was RMB687.1mn in 1Q22, vs a net loss of RMB267mn in 1Q21. Non-GAAP net income was RMB361.8mn, in the first quarter of 2022, -40.7% YoY. US GAAP basic and diluted net income per ADS were RMB0.528 and RMB0.521 in 1Q22, vs basic and diluted net loss per ADS of RMB0.174 in 1Q21. Non-GAAP basic and diluted net income per ADS were RMB0.284 and RMB0.281, vs RMB0.398 in 1Q21.
- Balance sheet remained strong, with the cash position of approximately RMB14.9mn (RMB14.4mn by 1Q21); positive operating cash flows in each of the past three years.

Figure 1: Earnings revision

RMB mn	New			Old			Diff (%)		
	FY22E	FY23E	FY24E	FY22E	FY23E	FY24E	FY22E	FY23E	FY24E
Revenue	5,949	6,425	7,240	9,650	12,578	NA	-38.4%	-48.9%	NA
Gross profit	2,426	2,641	3,001	4,188	5,567	NA	-42.1%	-52.6%	NA
EBIT	1,581	1,729	1,973	2,547	3,429	NA	-37.9%	-49.6%	NA
Net profit	1,377	1,490	1,676	2,198	2,903	NA	-37.3%	-48.7%	NA
EPS (RMB)	1.18	1.27	1.40	1.55	2.01	NA	-23.9%	-37.2%	NA
Gross margin	40.8%	41.1%	41.5%	43.4%	44.3%	NA	-2.6ppt	-3.2ppt	NA
EBIT margin	26.6%	26.9%	27.3%	26.4%	27.3%	NA	0.2ppt	-0.4ppt	NA
Net margin	23.1%	23.2%	23.2%	22.8%	23.1%	NA	0.4ppt	0.1ppt	NA

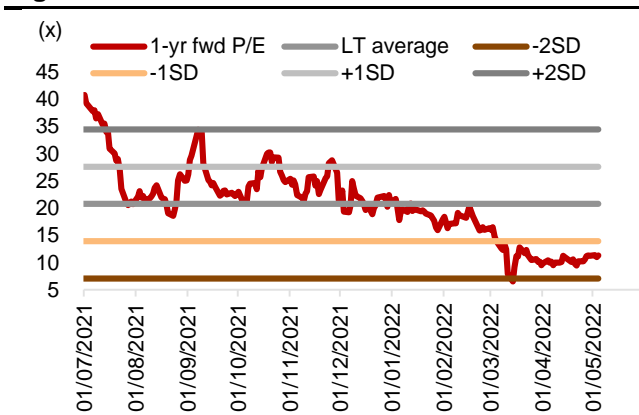
Source: Company data, CMBIGM estimates

Figure 2: CMBIGM estimates vs consensus

RMB mn	CMBIGM			Consensus			Diff (%)		
	FY22E	FY23E	FY24E	FY22E	FY23E	FY24E	FY22E	FY23E	FY24E
Revenue	5,949	6,425	7,240	7,131	9,603	14,165	-16.6%	-33.1%	-48.9%
Gross profit	2,426	2,641	3,001	NA	NA	NA	NA	NA	NA
Operating profit	1,581	1,729	1,973	1,332	1,453	2,196	18.7%	19.0%	-10.1%
Net profit	1,377	1,490	1,676	1,370	1,511	2,404	0.5%	-1.4%	-30.3%
EPS (RMB)	1.18	1.27	1.40	0.94	1.05	1.72	26.0%	20.7%	-18.6%
Gross margin	40.8%	41.1%	41.5%	NA	NA	NA	NA	NA	NA
Operating margin	26.6%	26.9%	27.3%	18.7%	15.1%	15.5%	7.9ppt	11.8ppt	11.8ppt
Net margin	23.1%	23.2%	23.2%	19.2%	15.7%	17.0%	3.9ppt	7.5ppt	6.2ppt

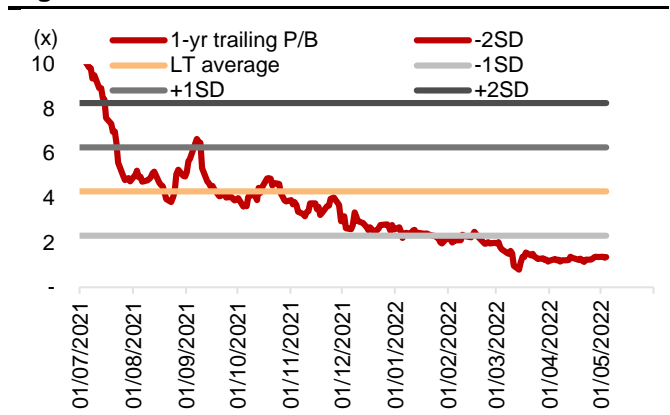
Source: Company data, CMBIGM estimates

Figure 3: P/E chart



Source: Bloomberg, CMBIGM estimates

Figure 4: P/B chart



Source: Bloomberg, CMBIGM estimates

Financial Summary

Income statement

YE 31 Dec (RMB mn)	FY20A	FY21A	FY22E	FY23E	FY24E
Revenue	3,820	8,521	5,949	6,425	7,240
Cartridges	2,842	7,491	4,626	5,036	5,731
Devices	978	1,030	1,323	1,389	1,509
Gross profits	1,528	3,672	2,426	2,641	3,001
D&A	(59)	(109)	(58)	(79)	(51)
Selling expense	(443)	(521)	(357)	(386)	(434)
Administration expenses	(772)	(673)	(357)	(386)	(434)
Other operating expenses	(240)	(71)	(73)	(63)	(108)
EBIT	13	2,299	1,581	1,729	1,973
EBITDA	72	2,407	1,639	1,808	2,025
Finance costs, net	32	72	52	52	52
Non-operating	20	94	57	57	57
Total investment	37	194	115	115	115
Pre-tax profit	102	2,660	1,806	1,954	2,198
Income tax	(231)	(631)	(429)	(464)	(522)
Less: Minority interests	-	(3)	-	-	-
Net profit (GAAP)	(128)	2,025	1,377	1,490	1,676
Net profit (non-GAAP)	801	2,248	1,601	1,713	1,900

Cash flow summary

YE 31 Dec (RMB mn)	FY20A	FY21A	FY22E	FY23E	FY24E
Net income	(128)	2,025	1,377	1,490	1,676
D&A	59	109	58	79	51
Change in working capital	870	(425)	(236)	(19)	52
Others	1,788	91	(127)	24	40
Net cash fr. operating act.	2,589	1,800	1,072	1,573	1,820
Capex & investments	(1,234)	(1,467)	(1,409)	(1,221)	(1,221)
Short term investment	(5,444)	(14,320)	-	-	-
Others	4,865	7,916	1,292	1,104	1,104
Net cash fr. investing act.	(1,813)	(7,871)	(117)	(117)	(117)
Equity raised	1,530	-	-	-	-
Change of Debts	-	-	-	-	-
Dividend paid	-	-	-	-	-
Others	(1,355)	9,904	-	-	-
Net cash fr. financing act.	175	9,904	-	-	-
Net change in cash	951	3,833	955	1,457	1,703
Cash at the beginning of the year	144	1,376	5,209	6,164	7,621
Exchange difference	19	-	-	-	-
Cash at the end of the year	1,114	5,209	6,164	7,621	9,324
Less: pledged cash	-	-	-	-	-

Balance sheet

YE 31 Dec (RMB mn)	FY20A	FY21A	FY22E	FY23E	FY24E
Non-current assets	193	2,414	2,420	2,468	2,550
PP&E/Fixed assets	75	143	201	236	298
Intangible assets	5	8	10	12	16
Right of use assets, net	92	176	123	133	150
Other non-current assets	21	2,086	2,086	2,086	2,086
Current assets	3,867	13,951	14,819	16,365	18,141
Cash	1,114	5,209	6,164	7,621	9,324
Account receivable	20	14	33	35	40
Inventories	329	589	483	570	639
Other current assets	2,404	8,139	8,139	8,139	8,139
Current liabilities	2,497	2,738	2,234	2,338	2,520
Borrowings	-	-	-	-	-
Account payables	1,460	1,289	965	1,037	1,161
Other payables	674	851	851	851	851
Rent payable	364	598	417	451	508
Non-current liabilities	55	109	109	109	109
Borrowings	-	-	-	-	-
Other non-current liabilities	55	109	109	109	109
Minority Interest	-	-	-	-	-
Total net assets	1,508	13,519	14,896	16,386	18,062
Shareholders' equity	1,508	13,519	14,896	16,386	18,062

Key ratios

YE 31 Dec	FY20A	FY21A	FY22E	FY23E	FY24E
Sales mix (%)					
Cartridges	74.4	87.9	77.8	78.4	79.2
Devices	25.6	12.1	22.2	21.6	20.8
P&L ratios (%)					
Gross margin	40.0	43.1	40.8	41.1	41.5
Operating margin	0.3	27.0	26.6	26.9	27.3
Pre-tax margin	2.7	31.2	30.4	30.4	30.4
Net margin	(3.4)	23.8	23.1	23.2	23.2
Effective tax rate	(225.1)	(23.7)	(23.7)	(23.7)	(23.7)
Balance sheet analysis					
Current ratio (x)	0.3	0.4	0.4	0.5	0.5
Net receivable days	1.9	0.6	2.0	2.0	2.0
Inventory turnover days	52.4	44.3	50.0	55.0	55.0
Net payable days	232.5	97.0	100.0	100.0	100.0
Net debt to equity (%)	Net cash	Net cash	Net cash	Net cash	Net cash
Returns (%)					
ROE	n.a.	15.0	9.2	9.1	9.3
Dividend yield	-	-	-	-	-
Per share					
EPS (RMB)	0.6	1.6	1.2	1.3	1.4
DPS (RMB)	-	-	-	-	-
BVPS (RMB)	1.0	9.6	11.0	12.1	13.3
EV/ EBITDA (x)	n.a.	4.3	5.1	3.7	2.3

Source: Company data, CMBIGM estimates

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