



YY Inc.

2Q15 Earnings Conference Call

August 13, 2015

Operator:

Good day everyone and welcome to YY's second quarter 2015 earnings conference call.

At this time all participants are in listen-only mode. We will be facilitating a question and answer session towards the end of this conference call. At this point, I would like to turn the call to Lili Huang, YY's Investor Relations Director.

Lili Huang - Opening Remarks and Safe Harbor Statement

Thank you, operator. Welcome to YY's second quarter 2015 earnings conference call. With me today is Mr. Eric He, CFO. I would also like to mention that due to the pending going-private transaction, we will not be hosting a Q&A session at the end of the call.

Before we begin, I refer you to the Safe Harbor Statement in our earnings release, which also applies to our conference call today as we will make forward-looking statements.

On behalf of our CEO, Mr. David Xueling Li, I would now like to discuss the strategic highlights for the quarter.

We are pleased to report another period of strong results for the second quarter of 2015, as revenues grew by 61% year over year to over 1.3 billion RMB. At the same time, we continue to grow, strengthen and diversify our interactive social platform as demonstrated by the 122 million monthly active users that now utilize YY's broad range of services.

For our core online music and entertainment business, it continued to see downward pressure due to weaker ARPU, a common theme among internet companies going through a mobile transition. This, however, was well compensated by a strong growth in the number of paying users, which was primarily driven by an increase in mobile users, resulting in a 42% increase in

revenue in the quarter. Mobile YY revenues increased over six fold year over year and 78% quarter over quarter, now accounting for nearly one third of all music and entertainment revenue. Meanwhile, online dating continued to impress, delivering a remarkable 438% year-over-year revenue growth. Last month, we launched a new version of our online dating mobile app, Xunhuan, which includes new features that aim to bring more social elements to the dating show.

Overall, it was a strong quarter. However, we have also seen potential headwinds that may create some uncertainties for a number of our businesses. The main issues are a stagnant online gaming market and increased competition from new players in the music and entertainment space. We do believe, however, that with our advanced proprietary technology, well-established ecosystem, and diversified business portfolio, we are well-positioned to deliver sustainable growth in the ever-changing and increasingly challenging competitive environment.

Finally, I would like to thank everyone that has been involved with making YY one of the leading real-time interactive social platforms in China for their continued commitment and support for the Company. We are excited about the Company's future as we continue to adapt to the evolving Internet landscape in China and provide new and innovative services to our community of users.

With that, I will hand it over to Eric.

Eric He – Financial Results

Thank you Lily. Good morning everyone.

As Lily mentioned, we continue to see strong growth in a number of our businesses. Since she has already discussed music and entertainment and online dating, I'll give a brief update on the rest, before we move on to our financial performance.

First is live game broadcasting. As we mentioned on the earnings call last quarter, we restructured the operating team. We have now created a new unit called Interactive Entertainment, which oversees all game-related businesses, i.e. online games, Huya game broadcasting, and our media portal Duowan.com. The purpose of this was to build a strong

ecosystem around games, through better cooperation and utilization of resources. So far, the team has made good progress improving user experience and engagement on Huya game broadcasting, which, in turn, boosted revenue growth. In addition to improving speed for live streaming, the team also launched a number of new product initiatives in the last quarter. Moreover, the team has further enhanced our ecosystem by introducing a nobility system that is similar to the one in music and entertainment. All of these features aim to increase user satisfaction and engagement, which we believe is crucial in an increasingly competitive environment. So far, the results are encouraging.

Moving on to online games. We saw revenues grow by nearly 20% year over year, despite against a weak quarter last year. We have made good progress on further expanding our client-based game portfolio by signing four more exclusive new games, including the acclaimed Swords of Legends (古剑奇谭), which is scheduled to be launched early next year. However, the continuously worsening market conditions for web games and the slower than expected ramp-up of the new client-based games has caused us to reassess and revise our full year expectation for online games. We now anticipate very limited growth for this business this year.

As for 100 Education, in the second quarter, we conducted an operational review following a departure of key personnel in the English-training business we acquired at the end of last year. Subsequently, we incurred a one-off goodwill impairment write-down of 111 million RMB. Due to this unexpected outflow of teachers, we have reduced our forecast for the business and made an adjustment of 110 million RMB to our estimate accordingly on the contingent payment for the potential earn-out related to this specific acquisition. Both items were also reflected in the Balance Sheet and created no P&L impact.

Finally, I'd like to talk about our margin situation. Similar to what we saw in the first quarter, gross margin dropped by 11% year-over-year, or 3% quarter-over-quarter. The main reason was due to the increased revenue sharing costs, which was primarily driven by the shift in revenue mix. I'd like to remind everyone that most of our new business lines such as education and finance have a higher revenue sharing arrangement given their intensive knowledge-based nature. Furthermore, the higher revenue sharing ratio was also caused by stronger-than-expected increase in deferred revenues in online music and entertainment, which was mainly due to successful marketing campaign in June. The associated higher revenue sharing cost was paid as occurred, thus, recorded on a cash basis, which temporarily dampened gross

margin in second quarter. In addition to these two reasons, higher bandwidth cost and D&A of servers and office equipment were amongst the main contributors to the lower gross margin. As we will see a continuing shift in our revenue mix away from high margin businesses such as online games and the membership program to lower margin user-generated content business lines and new business initiatives, we now expect our gross margins to be somewhat under pressure for the rest of the year. However, we plan to mitigate some of this impact by improving operating efficiency, which we have already seen in the second quarter. Together with increased economies of scale, we will improve our operating leverage and allow our overall profitability to remain relatively stable for the remainder of the year.

One non-recurring item worth mentioning in the second quarter, we received a government grant of 22 million RMB related specifically to the tax years 2013 and 2014 and a 6 million RMB VAT refund. Both were recorded in the other income line..

Now I'll move on to our quarterly financial details:

Before I get started presenting our financial numbers, I'd also like to clarify that all the financial numbers we are presenting today are in Renminbi amounts and percentage changes are year-over-year comparisons, unless otherwise noted.

Net revenues for the second quarter 2015 increased by 61% to 1.36 billion. This increase was primarily driven by an increase in IVAS revenues.

IVAS revenues increased by 62% to 1.30 billion. The overall increase primarily reflected an increase in the number of paying users. Let's look at each of our IVAS business lines more specifically.

- **Revenue from online music and entertainment** increased by 42% to 731 million. This increase primarily reflected a 62% increase in the number of paying users to 1.8 million as well as a 13% decrease in ARPU to 400 during the second quarter 2015.
- **Revenue from online games** increased by 20% to 199 million. This increase primarily reflected a 2% decrease in the number of paying users to 428,000 and an increase in ARPU of 22% to 466; Also, the number of online games increased to 246 as of June 30, 2015, from 150 a year before.

- **Revenue from online dating** increased by 438% to 157 million. This increase primarily reflected a 162% increase in the number of paying users to 233,000 and an increase in ARPU of 105% to 675.
- **Revenue from others** increased by 141% to 213 million. This includes revenue from Huya game broadcasting, which increased by 174% to 85 million, and revenue from the membership program, which increased by 49% to 73 million. The revenue increase in the membership program primarily reflected a 17% increase in the members to 1,073,000 as of June 30, 2015.

Other revenues, which mainly includes 100 Education and online advertising revenues from Duowan.com, were 57 million in the second quarter 2015, compared to 40 million in the corresponding period of 2014.

Cost of revenues increased to 833 million. This was primarily attributable to an increase in revenue sharing fees and content costs, which increased to 552 million this quarter from 256 million last year. The reason for this increase was explained earlier. In addition, bandwidth costs increased to 132 million, representing 10% of revenues, due to providing better quality broadcasting streams to our online game broadcasting users and utilizing higher resolution videos.

Gross profit increased by 26% to 524 million. Gross margin dropped by 11 percentages year-over-year to 39%. The decrease in gross margin was mainly attributable to the change in our revenue mix, higher revenue sharing fee and content cost, and the increased bandwidth costs related to Huya game broadcasting and general business expansion.

Our non-GAAP operating income increased 16% to 319 million. Non-GAAP operating margin fell by 9 percentages year-over-year to 24%, primarily driven by the decrease in gross margin for the reasons listed above, but compensated by the improved operational efficiency.

GAAP net income attributable to YY increased 31% to 291 million from 222 million. GAAP net margin was 21%, representing a 5 percentages decline year-over-year..

Non-GAAP net income attributable to YY increased by 17% to 302 million, while non-GAAP net margin reduced to 22%.

Diluted net income per ADS increased by 37% to RMB5.10 or 82 US cents from RMB3.71 in the same quarter last year. Non-GAAP diluted net income per ADS increased by 22% to RMB5.29 or 85 US cents from RMB4.32 in the corresponding period of 2014.

This concludes our prepared remarks. Thank you for joining our call today, and we would now like to conclude the call.