

Huatai Research

4 February 2019

Equity | China | Internet Based Services

BUY | TP USD7.20

Maintained

Conservative on 2019 outlook

4Q results in line; cautious on 1Q19 outlook

Sogou Inc (Sogou) reported 4Q18 and full-year results before the US market opened on 1 February. In 4Q18, revenue reached USD297.8mn, up 7.2% yoy and 7.7% qoq, in line with market expectations. Full-year revenue grew 23.8% yoy to USD1.1bn. For 4Q18, net profit under GAAP reached USD26.4mn, up 71.3% yoy and 10.3% qoq. The GAAP earnings beat consensus by 10.2%, primarily due to a decrease in share-based compensation expense. Full-year net profit grew 70.9% yoy to USD98.8mn. Management guided 1Q19 revenue in the range of USD231mn-USD241mn, a 3-7% yoy decrease (or 1-5% yoy increase in RMB terms), taking into consideration economic impacts on search advertising and a decrease in smart hardware sales.

Improve monetization capability to boost search revenue growth

Sogou search and search-related revenue grew 12.0% yoy and 8.4% qoq to USD276.8mn in 4Q18, higher than the industry average. Sogou's search revenue growth in 2019 will be mainly driven by improving monetization capabilities, while search traffic will grow at a mild rate. Revenue from Other business was down 31.5% yoy and 1.4% qoq to USD21.0mn in 4Q18, due an adjustment in hardware strategy. We expect the new AI-based hardware product to be launched in 2H19, which should lead to recovery for Other revenue in 2019.

Gradually increasing organic traffic contribution to stabilise TAC

Sogou's GPM was 37.5% in 4Q18, down 14.2pp yoy but up 0.3pp qoq. Traffic acquisition cost (TAC) as a percentage of search revenue was 54.1% in 4Q18 (3Q18, 53.0%; 4Q17, 36.0%). Management expects the growth of TAC to normalize in 2019, by increasing Sogou's organic traffic contribution and being more selective in traffic acquisition. OPM under GAAP was 4.2% in 4Q18, down 3.2pp yoy but up 6.7pp qoq. The quarter on quarter improvement was mainly due to a decrease in share-based compensation expense.

Sogou Mobile Keyboard and AI to drive long-term growth

Sogou Mobile Keyboard's daily average users (DAU) reached 430mn in 4Q18, up 29.9% yoy and 6.2% qoq, making it the third-largest app in China by DAU per iResearch. We believe Sogou will launch more innovative functions to monetize its large traffic, and will provide more synergies to its core search business. We expect traffic contributed by organic channel increase to 30% by end-2019. In 4Q18, organic/Tencent/OEM channels contributed 27/36/37% of total traffic.

Financials

YE 31 Dec	FY16	FY17	FY18E	FY19E	FY20E
Revenue (USDmn)	660	908	1,131	1,399	1,676
yoy%	11.6	37.5	24.5	23.7	19.8
Net profit (USDmn)	28	58	78	87	112
yoy%	(60.8)	106.3	35.0	11.1	28.7
EPS (diluted, USD)	0.104	0.201	0.197	0.218	0.279
PE (x)	58.8	30.3	30.9	28.0	21.8
PB (x)	8.7	1.7	2.4	2.2	2.0
EV EBITDA (x)	26.2	13.7	17.2	14.5	11.4
Dividend yield (%)	0.0	0.0	0.0	0.0	0.0
Free cashflow yield (%)	4.5	7.6	(14.1)	2.0	3.1

Source: Company data, Huatai HK Research estimates

Huatai Financial Holdings (Hong Kong) Limited is abbreviated as Huatai HK throughout this report.

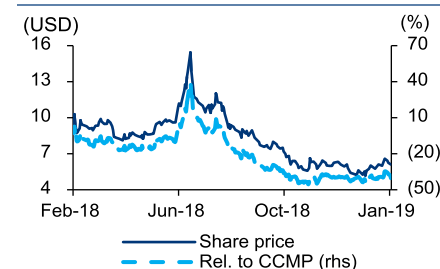
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Key data

Target price (USD)	7.20
Closing price (USD as of 1 Feb)	6.10
Upside +/- (%)	18
Mkt cap (USDmn)	2,414
6m avg daily val (USDmn)	10.77
52wk price range (USD)	15.43/5.19
BVPS (USD)	3.53

Share performance



Source: FactSet

Business update after post-results conference call

Search and search-related advertising business (93% of 4Q18 revenue)

Sogou's core search revenue grew faster than the industry average in 4Q18, with search revenue growing 12.0% yoy and 8.4% qoq to USD276.8mn, primarily driven by improving monetization capabilities (3Q18: search revenue up 13.2% yoy but down 5.7% qoq). Auction-based pay-for-click services accounted for 84.8% of search and search-related revenues. Compared to other top domestic search engines in China, Sogou's monetization capability still has ample room to grow, which will be the main search revenue growth driver in the next few years, in our view.

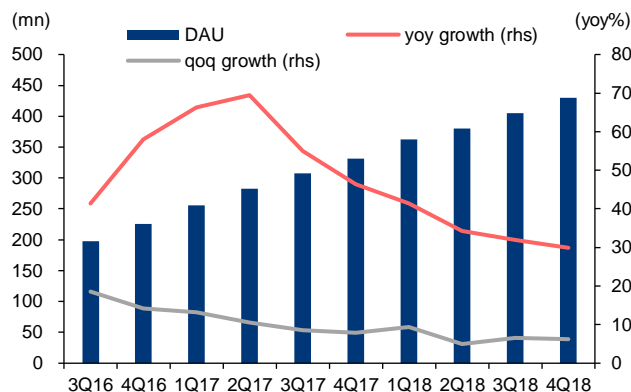
Sogou management stated that the company will continue to focus on improving the quality of search results and enrich its content and Q&A search. For instance, Sogou established a healthcare content-related ecosystem, exclusively offering authoritative medical guideline to users. As a result, the number of healthcare queries in mobile search and click-through rate has risen steadily. We believe the high-quality content will drive the organic traffic growth of Sogou for the long term.

Fig.1. Sogou: revenue trend



Source: Company data, Huatai HK Research

Fig.2. Sogou: DAU of Sogou Mobile Keyboard



Source: Company data, Huatai HK Research

Other business (7% of 4Q18 revenue)

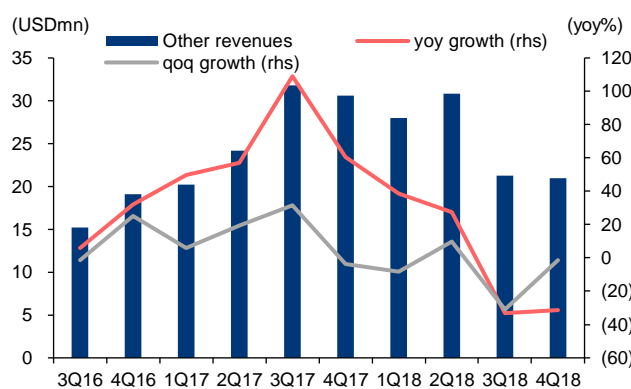
Management guided Other revenue in 2019E will grow strongly, primarily driven by contribution from its smart hardware initiatives. AI-enabled hardware products sales will make full-year revenue contribution in 2019. We believe Sogou can create more competitive products with leading AI technologies to achieve long-term growth, while 1H19 revenue from Other business may still under pressure during the transition period.

Fig.3. Sogou: search and search-related revenues



Source: Company data, Huatai HK Research

Fig.4. Sogou: Other revenues

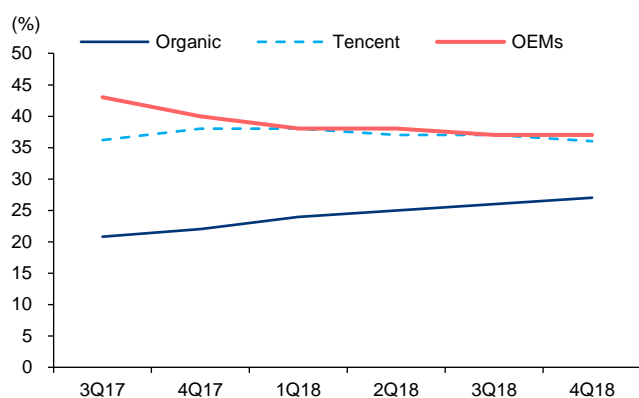


Source: Company data, Huatai HK Research

Traffic acquisition costs will continue to put pressure on TAC in 2019

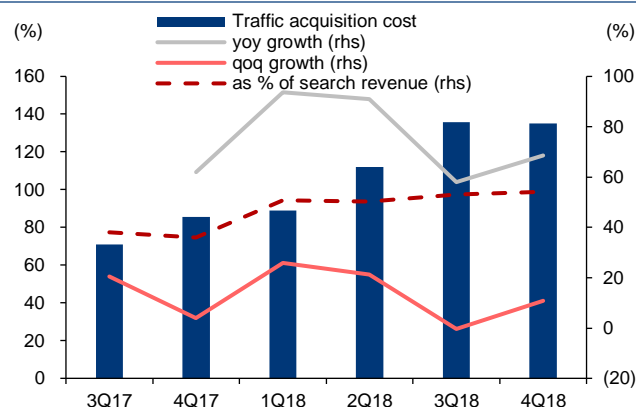
Management expects TAC as a percentage of search revenue to stabilize in 2019, as the company plans to be more selective on the choice of traffic acquisition channel, ceasing cooperation with less effective channels. Also, Sogou will continue to increase traffic contribution from organic channels by leveraging the large traffic of Sogou Mobile Keyboard, and also by optimizing the search results. As long as Sogou can increase organic traffic from its own channels, its TAC as a percentage of revenue will gradually trend down in the long run.

Fig.5. Sogou: traffic mix



Source: Company data, Huatai HK Research

Fig.6. Sogou: traffic acquisition cost



Source: Company data, Huatai HK Research

Full financials

Income statement

YE 31 Dec (USDmn)	FY16	FY17	FY18E	FY19E	FY20E
Revenue	660	908	1,131	1,399	1,676
Cost of goods sold	(303)	(457)	(685)	(840)	(1,006)
Gross profit	358	451	445	560	670
Selling and distrib cost	(123)	(156)	(156)	(181)	(210)
Admin expenses	(25)	(28)	(41)	(38)	(42)
Others oper inc/exp	(138)	(173)	(214)	(266)	(318)
Operating profit	72	94	34	76	101
Financial cost-net	5	9	9	10	10
Share of P&L of assoc	0	0	0	0	0
Others inc/exp	(21)	(6)	40	10	12
Profit before tax	56	97	83	95	123
Tax expense	(0)	(14)	(5)	(9)	(11)
Minority interest/other	(28)	(24)	0	0	0
Net profit	28	58	78	87	112
Depr and amortization	35	50	57	67	76
EBITDA	86	137	131	153	189
EPS (USD basic)	0.119	0.225	0.202	0.223	0.286

Cash flow statement

YE 31 Dec (USDmn)	FY16	FY17	FY18E	FY19E	FY20E
EBITDA	86	137	131	153	189
Financing costs	5	9	9	10	10
Chg in working capital	50	31	(366)	10	20
Tax	(0)	(14)	(5)	(9)	(11)
Other	8	19	0	0	0
Operating cash flow	150	182	(231)	165	208
Capital expenditure	(85)	(62)	(103)	(118)	(133)
Other investing activ's	(9)	(345)	0	0	0
Investing cash flow	(95)	(407)	(103)	(118)	(133)
Increase in debt	0	0	0	0	0
Increase in equity	0	619	0	0	0
Dividends paid	0	0	0	0	0
Other financing activ's	0	0	0	0	0
Financing cash flow	0	619	0	0	0
Change in cash	55	394	(334)	47	75
Cash at start of year	244	286	694	361	407
Effect of forex rate chg	(13)	14	0	0	0
Year-end cash	286	694	361	407	482

Balance sheet

YE 31 Dec (USDmn)	FY16	FY17	FY18E	FY19E	FY20E
Inventories	0	0	0	0	0
Acc & bill receivable	67	73	98	120	143
Cash & cash equiv	286	694	361	407	482
Other current assets	7	354	765	769	773
Total current assets	360	1,121	1,224	1,296	1,398
Fixed assets	117	139	186	237	293
Intangible assets	2	1	0	0	0
Other long-term assets	45	59	59	59	59
Total long-term assets	165	200	246	296	353
Total assets	525	1,321	1,470	1,592	1,751
Accounts payable	48	73	94	112	131
Short-terms loans	132	164	191	208	222
Other liabilities	179	176	198	199	213
Total current liabs	359	413	483	519	566
Long-term debt	0	0	0	0	0
Other long-term liabs	0	0	0	0	0
Total long-term liabs	0	0	0	0	0
Equity	239	886	886	886	886
Reserves/other items	(73)	23	101	187	299
Shareholder equity	166	908	986	1,073	1,185
Minority interest	0	0	0	0	0
Total equity	166	908	986	1,073	1,185
BVPS (USD basic)	0.70	3.53	2.55	2.76	3.03

Valuation

YE 31 Dec (x)	FY16	FY17	FY18E	FY19E	FY20E
PE	58.8	30.3	30.9	28.0	21.8
PB	8.7	1.7	2.4	2.2	2.0
EV EBITDA	26.2	13.7	17.2	14.5	11.4
Dividend yield (%)	0.0	0.0	0.0	0.0	0.0
FCF yield (%)	4.5	7.6	(14.1)	2.0	3.1

Performance

YE 31 Dec	FY16	FY17	FY18E	FY19E	FY20E
Growth (%)					
Revenue	11.6	37.5	24.5	23.7	19.8
Gross profit	4.1	26.1	(1.3)	25.7	19.8
Operating profit	(29.6)	31.1	(64.0)	123.4	33.1
Net profit	(60.8)	106.3	35.0	11.1	28.7
EPS	(61.7)	89.5	(10.2)	10.6	28.1
Profitability ratios (%)					
Gross profit	54.2	49.6	39.4	40.0	40.0
EBITDA	13.0	15.1	11.5	10.9	11.3
Net profit	4.2	6.4	6.9	6.2	6.7
ROE	20.1	10.8	8.2	8.4	9.9
ROA	6.0	6.3	5.6	5.7	6.7
Solvency (x)					
Net gearing ratio (%)	(92.9)	(58.3)	(17.2)	(18.6)	(22.0)
Current ratio	1.0	2.7	2.5	2.5	2.5
Quick ratio	1.0	2.7	2.5	2.5	2.5
Operating capability (days)					
Total assets t/o ratio (x)	1.3	0.7	0.8	0.9	1.0
Receivable	37	29	31	31	31
Payable	56	57	49	48	47
Inventory	n/a	n/a	n/a	n/a	n/a
Cash conversion cycle	n/a	n/a	n/a	n/a	n/a

Source: Company data, Huatai HK Research estimates

Valuation methodology and risks statement

Our target price of USD7.2 is based on 23x 2019E PE on non-GAAP EPS of USD0.31, with a 2018E-2020E non-GAAP earnings CAGR of 13.8%.

Downside risks to our view: 1) competition among search engines intensifies, raising traffic acquisition cost; and 2) slower-than-expected search revenue growth in macro risks.

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