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# EDITED TRANSCRIPT

2498.TW - Q2 2013 HTC Corporation Earnings Conference Call

EVENT DATE/TIME: JULY 30, 2013 / 7:00AM GMT



## CORPORATE PARTICIPANTS

**Christine Chi** *HTC Corporation - IR Manager*

**Peter Chou** *HTC Corporation - CEO*

**Chialin Chang** *HTC Corporation - CFO*

## CONFERENCE CALL PARTICIPANTS

**Arthur Hsieh** *UBS - Analyst*

**Alban Cousin** *Arete Research - Analyst*

**Alvin Kwok** *JP Morgan - Analyst*

**James Faucette** *Pacific Crest - Analyst*

**Judy Chen** *Harvest Global Investments - Analyst*

**Robert Yen** *Goldman Sachs - Analyst*

**Anne Lee** *Nomura - Analyst*

**Jean-Louis Lafayeedney** *Jl Asia - Analyst*

**John Lopez** *Vertical - Analyst*

## PRESENTATION

### Operator

Welcome everyone to HTC's 2013 Q2 results conference call, and a webcast in English. Today with us, we have CEO Mr. Peter Chou, CFO, Mr. Chialin Chang, the IR (technical difficulty). All lines have been placed on mute to prevent background noise. After presentation, there will be a question and answer session for the investor and analysts. Please follow the instruction given at that time if you would like to ask a question.

For your information, this conference call is now being broadcast live over the internet. Webcast replay and English transcript will be available within an hour after conference is finished. The Chinese translated transcribe will be available with the [NFC] after conference is finished. Please visit [www.htc.com](http://www.htc.com) under the Investors section. Now, I would like to introduce Ms. Christine Chi, IR Manager. Ms. Chi, you may begin.

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### Christine Chi - HTC Corporation - IR Manager

Hi. Good morning, good afternoon and good evening, ladies and gentlemen. Welcome to HTC's 2013 second quarter analyst call. This is Christine Chi, HTC's IR Manager.

The event is now being broadcast live via HTC's website at [www.htc.com](http://www.htc.com). If you are joining us through the dial-in line, your call is now being placed on mute. As this conference is broadcasted by investor around the world, we will conduct this call in English only. Both English and Chinese transcript will be available on Company's website after the call. The format for today's call will be as follow. I will have to summarize our operations for second quarter of 2013, followed by our guidance for the third quarter of 2013. Afterwards HTC's CEO Peter Chou, and CFO Chialin Chang will lead the Q&A session.

Before we begin, I would like to draw your attention to the disclaimer statement on page 2. Please note that this presentation contains forward-looking statements. These statements are based on our current expectations. Current results may differ materially from our expectation and the Company undertakes no obligation to update these forward-looking statements going forward. If you have no questions, I may begin to give the overview for second quarter of 2013. Please turn to page 3 of the presentation.



Page 3, second quarter financial highlights. Revenues for second quarter was TWD70.7 billion, with gross margin of 23.2% and operating margin of 1.5%. Net profit was TWD1.2 billion and EPS was TWD1.5 per share.

Business update; the US saw sequential growth in second quarter as well as expansion in retail channel. EMEA saw renewed strength in major Western European markets and emerging countries. Progress was observed across Asia. HTC gained market share in Taiwan, showing an improved presence in Hong Kong and warm reception of its products by consumers in Japan.

In China, sales of HTC's high end model improved, while competition in the mid-tier and affordable intensified. In South Asia, the improvement of key operator relationship provide optimism about the region.

Page 4, recent appointment; we recently announced Jack Yang to be the President of our South Asia business, previously the Head of iPhone and iPad Sales in Southeast Asia for Apple; Sirpa Ikola to be our Senior Director of Marketing for South Asia, previously Head of Smart Devices in Southeast Asia, Nokia. And Lorain Wong to be the Vice President of Global PR, Corporate and Internal Communication, previously Senior Vice President, Marketing & Communications for Pacnet and earlier Director of Partnership Marketing for AT&T.

Page 5. Page 5 gives a overview of the revenues and operating profit. Revenue for second quarter came in at TWD70.7 billion. Operating profit for second quarter was TWD1.1 billion. Page 6, page 6 gives an overview of the gross margin and operating margin. Gross margin for second quarter was up from first quarter, came in at 23.2%, and operating margin for second quarter was also better than first quarter, came in at 1.5%.

Page 7 and 8 were financial overview for financial -- income statement and balance sheet. Page 9, guidance for third quarter of 2013. Revenue is expected to be in the range of TWD50 billion to TWD60 billion. Gross margin is expected to be in the range of 18% to 21%. Operating margin is expected to be in the range of 0% to negative 8%. This wraps up our presentation.

Now, I would like to turn the podium to HTC CEO Peter Chou.

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**Peter Chou - HTC Corporation - CEO**

Hello. Hi, good afternoon. It's my pleasure to be here today to share with you HTC's status and also would like to answer questions from you. So before that, I would like to share with you some of the status here at HTC. So of course number one is HTC One. So HTC One has been performing very well in the market so far and we are seeing in China, in US, in EMEA, they all perform quite well and also help us to establish strong brand awareness. And it also received mainly strong recognition in the industry, and of course we will continue to push in HTC to gain even more momentum in the market the rest of the year.

And we also just launched HTC One Mini as a complete HTC One series. And it shared most of the HTC One experience and key features. So the goal is to establish stronger HTC product franchise brand and we have quite strong demand so far and we are actually shipping end of this month HTC One. We are also having a series of new mid-tier products coming end of this quarter, early next quarter. So this series of mid-tier products will help us to regain momentum and market share in this segment in Q4, and this will address some of our challenge of mid-tier product competitiveness. So we suffer a little bit in this mid-tier market share from end of last year to so far due to intensive competition in the market. However, this new range of mid-tier products will address those challenges.

So in Q3 we have seen overall gross margin challenges. The main reasons are number one, I think HTC One cost structure is high and we had expected it will be improving. However, the improvement is not where we wanted to be for because the lack of the overall economic scale, so we have a lot of overhead we had to share, so it made HTC One gross margin higher. So it impact our gross margin. So we are taking actions to make this -- to improve, and then we are expecting to see these improvement in Q4.

And we are, of course, also optimizing our organization including management efficiency and effectiveness, and the integration of all the execution, so that it will help us to really leveraging the experience we learn from the past and we can perform better in whatever product and cost and deliveries and efficiency, those things.



And of course people, talent, innovation and technology are always the core asset of HTC, and we will continue to invest in innovations and technology as well as maintaining and retaining and rewarding our best talents. So we are having employee incentive programs and we are going to execute so that we can keep our key people so that we can continue to push our innovative product, the best product to the market.

And of course HTC has been the Company with the -- always working on to create new value. So we are actually working on several things both in product category and potential partnerships and we're hoping that this will help us to strengthen our competency in the market next year. So these are the message I would like to share with you. And thank you.

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**Christine Chi** - *HTC Corporation - IR Manager*

Moderator, we can start the Q&A session.

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## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions). Arthur Hsieh, UBS.

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**Arthur Hsieh** - *UBS - Analyst*

I just want to get a bit more clarity in terms of HTC One. Apparently, this is a really nice phone and it has received overwhelming positive reviews. Is there any way that you can share with us how is the momentum going and is there any chance for this product to achieve certain economies of scale? Judging by the guidance apparently this is not happening. So why is such a beautiful phone not really selling well? Could you give us a bit more clarity? Thank you.

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**Chialin Chang** - *HTC Corporation - CFO*

Hi, Arthur, thank you for the question. This is Chialin and Peter wanted me to answer this question. Just a few things. First of all, HTC One, as Peter mentioned in the very beginning comment, HTC One actually is performing well. If you compare HTC One with -- in terms of sell out, in terms of our internal data compared to the Hero products we have, in fact the combined Hero product we have over last year -- over the same period last year it actually performed better.

Yes, we do have impact on the third quarter financial, you can see in the guidance there, primarily coming from the mid end and affordable end of the market. We may have some holes which we are fulfilling it. We're launching the new product there, increase the competitiveness in terms of price performance ratio there. So we do need to improve in that area.

At the same time we continue working, putting all the efforts on to extend the momentum in major markets in both Western and the China market for the HTC One, because we think it's important to establish -- use that to establish and further strengthen our brand awareness and [be in] consideration.

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**Arthur Hsieh** - *UBS - Analyst*

Hi. So in terms of the third quarter sales potential decline are you trying to suggest it's mainly coming from non-HTC One models? And all the potential downside in the margins is caused by the non One models?



**Chialin Chang** - HTC Corporation - CFO

We probably can give you -- cannot give you a more detailed granularity in that. In terms of sales momentum, yes, we do have impact on the sales momentum from the mid to affordable end, which we talked about in the last -- just now. The second thing is that obviously some of the effort put into cleaning some of the channel inventories, it do have impact on the financials. In terms of -- on the old product, aging product, a lot of them -- actually, quite a few from last year.

In terms of the -- just to be more specific, in terms of the HTC One gross margin cost structure here we will continue to improve on that. We are actually seeing the sequential improvement over the second quarter, we will continue to improve over that in to the rest of third quarter and into the rest of the year.

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**Arthur Hsieh** - UBS - Analyst

Thank you. So in terms of the potential cost reduction, could you share with us where could be the source of cost reduction?

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**Chialin Chang** - HTC Corporation - CFO

In terms of the overall product cost on this one -- the impact on a gross margin perspective here would be obviously the area in terms of bill of materials as well as the manufacturing cost there. Obviously, we're also taking effort in terms of the improving, optimizing overall cost structure from the operating perspective to improve on the operating level. So both sides, we're working on.

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**Peter Chou** - HTC Corporation - CEO

Yes, the improvement also came in from some of the key components, like [display], mechanical, several key components that we're seeing improvement in Q4.

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**Arthur Hsieh** - UBS - Analyst

Thank you. Last question is about the product strategy. I think, so far it seems HTC is more focused on the high-end segment, and as Peter mentioned that going to the end of the quarter there will be a series of mid-range products that could improve the overall competitiveness. Could you share with a bit more in terms of how do you expect that mid-range product could really help? Because we know that overall market is quite polarized, demand is usually higher in the high-end and also low-tier segments. Mid-range actually is quite a tricky segment, and it seems like you're trying to address the mid-range market segment?

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**Peter Chou** - HTC Corporation - CEO

I think that we have some mid and also we have some sort of maybe affordable entry level as well. So we're trying to see both. So the market right now is a little bit confused right now, because there are too many products coming out and so that that's why we are planning to have a new range of product, try to stay competitive in the market.

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**Arthur Hsieh** - UBS - Analyst

Got it. Thank you.

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**Peter Chou** - HTC Corporation - CEO

Thank you.

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**Operator**

Alban Cousin, Arete Research.

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**Alban Cousin** - *Arete Research - Analyst*

I guess, I mean just in a broader -- flipping back a little bit, and you are seeing margins now negative, 0% to minus 8%, and it sounds like you attribute that really essentially to the issue of the HTC One. But I mean, what's -- except from HTC One, what are the margins for the business now and how do you expect to improve that in the mid-range?

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**Peter Chou** - *HTC Corporation - CEO*

Well, the margin challenge we have, we have from some of the aging products. I have to say, some of the aging mid-end products, then also some of the inventory we have in the channel, so the aging product we have to kind of clean up so that -- that caused margin challenge for us in Q3.

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**Alban Cousin** - *Arete Research - Analyst*

Do you expect that mid-tier products will have above gross margin?

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**Peter Chou** - *HTC Corporation - CEO*

The new mid-tier product will have a definitely improved gross margin.

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**Alban Cousin** - *Arete Research - Analyst*

So they will have above 21% gross margin?

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**Chialin Chang** - *HTC Corporation - CFO*

We can't give you specifics.

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**Peter Chou** - *HTC Corporation - CEO*

Yes, we can't give you specifics.

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**Alban Cousin** - *Arete Research - Analyst*

Okay. Thanks.

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**Peter Chou** - *HTC Corporation - CEO*

Sure.

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**Operator**

Alvin Kwock, JP Morgan.

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**Alvin Kwock** - JP Morgan - Analyst

I got one question regarding the high overhead and also low scale. While this has been going on for quite a while by now, so I just wonder, if there is any strategic plan to address the issue specifically? I think you guys have made a specific [factory] expansion a couple of years ago, and obviously, you guys got a pretty big talented engineer pool as well. So is there a plan to address the over-capacity issue in both the factory and also the engineering resources side. I just wonder if you guys got any plans on that?

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**Chialin Chang** - HTC Corporation - CFO

I will answer this question here. First of all, the cost structure, what you're referring to and what we talked about, I don't think they are exactly the same thing. We expand the manufacturing (inaudible) we planned for future down -- a few years down the road there.

Indeed, if you have a big capacity and then you have the unit not meeting the full potential of manufacturing capacity, then you suffer a bit on the manufacturing cost side of things. The manufacturing cost side of things is a part of it. I wouldn't say a very small part but indeed on the grand scheme of things it's a small part of the whole overall cost in that regard, that's number one.

Number two, I just want to address your question directly. On the engineering resources side, we have very, very good engineering talent and very competitive engineering talent compared to other benchmark, some of them I mentioned during the shareholder meeting there. So I don't think that's a cost issue in that regard.

The cost issue we talked about here on the product level here on the BOM cost, some of the manufacturing and some of the other part of the things here. On the BOM cost, Peter has provided some granularity on some of the things there.

And obviously there is operating cost structure in there. We are going to have to improve the efficiency and effectiveness there, but I don't think that's the engineering talent part of it.

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**Alvin Kwock** - JP Morgan - Analyst

Okay. And my second question is on scale. So, you guys obviously have a really good product that has come out, but I think the scale is still fatty. It's too fat, it's still not big enough, so is there any other way further in terms of branching out to some other product category or some other strategic plans in, for example, some potential M&A activity, anything that you guys got in mind in how to address this scale issue?

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**Peter Chou** - HTC Corporation - CEO

Yes, definitely, scale is one of our challenges, and we recognize that. And we think that this is kind of growing process we are facing right now because the market is quite competitive right now, but however, at the same time HTC, we are investing a lot in many areas to establish our long-term [value].

For example, we are spending a lot of marketing to -- especially our brand in -- everywhere like in China. Actually China, this year we have gained a lot of good, very strong product awareness and we gained a lot of high end smartphone share in China. But however it would take some time for us to really, really grow big and -- but the key is it's so important we need to stay focused, and then keep working on the innovations, the product and marketing, and of course the efficiencies and the competitive costs, all these -- operation (inaudible) are important.



So we believe, over time, brand is so important and brand (inaudible) consumers kind of purchasing decisions. So making sure strong brand image -- a strong brand preference is so important and established product value is so important. And of course I mentioned briefly, we are definitely looking into new product opportunities and even new partnership opportunity, and we would continue to look into those areas and we are hoping maybe next year we will have some opportunity there.

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**Alvin Kwock** - *JP Morgan - Analyst*

Okay. Thank you.

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**Peter Chou** - *HTC Corporation - CEO*

Thank you.

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**Operator**

(Operator Instruction). James Faucette, Pacific Crest.

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**James Faucette** - *Pacific Crest - Analyst*

I am wondering if you can talk a little bit about your expectations for sell-through, and can you talk about what sell-through was in the second quarter versus the first quarter, obviously, with the launch of the HTC One, and what do you expect with for sell-through in Q3. Are we [leading] the channel through improved sell-through or is sell-through also coming down in anticipation of new handset launches.

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**Chialin Chang** - *HTC Corporation - CFO*

Let me answer this question here. First of all, the sell-through, in fact it would be fine to sell in, sell through and sell out, all better in second quarter compared to first quarter. But I don't think that's a right quarter-over-quarter comparison given the performance in first quarter here.

When we mentioned the HTC One, I think that's obviously our flagship product. When we say it performed well compared to the performance of the Hero product last year for the same period, actually a few -- quite a few Heros are combined. We are actually talking about the sell out. So we do mention the actual sell out to the consumers. So I will just pause there.

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**James Faucette** - *Pacific Crest - Analyst*

Great. Thank you. And in the second quarter, do you think that you were able to reduce your channel inventory of the mid-range products overall, ahead of the refresh that you are expecting at the end of the third quarter?

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**Chialin Chang** - *HTC Corporation - CFO*

I think in the second quarter we make improvement there. We will continue to improve. We'll clean out some of the materials that we have in there, so just making sure we empty the pipe, so in order for launching more competitive product here which we are very optimistic going into later this quarter and into the rest of the year.



**James Faucette** - *Pacific Crest - Analyst*

Great. And then can you just -- I know you may have talked about it in the past, but can you give us a view on how you think about your dividend policy at this point now that you are hovering around breakeven and what you would expect to do there. Should we expect you to pay and look at paying a percentage of your earnings as those return or would you expect to continue to pay dividend even as you are around breakeven or a little less here in the near term?

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**Chialin Chang** - *HTC Corporation - CFO*

I think first of all you got to understand from a Taiwan regulatory perspective here there is a constraint in that regard. To answer your question directly on two points, one, it always -- first priority in look at our strategic needs, the business needs in the coming years. That's always the number one overwhelming consideration. After that, we'll look at a few considerations in terms of bench marking and in terms of determining the final payout.

One of the big -- the consideration is indeed the payout ratio, i.e., the earning, the EPS we have, what kind of ratio or the range of ratio we will consider in paying out a cash dividend. So that's the consideration, and obviously subject to the whole overall regulations in Taiwan.

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**James Faucette** - *Pacific Crest - Analyst*

Great. And then my last question is you talked about your optimism that you have for the Chinese market in the high-end. Can you talk about how you define the high-end segment of the China market, kind of what price does that start from and are you seeing growth in the high-end market in China or do you need to take share directly from others in order to continue to grow there. Thank you very much.

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**Chialin Chang** - *HTC Corporation - CFO*

The high end market we defined is above -- the retail price is RMB4,000 and above. Sometimes people define RMB3,000 but we -- in our world we actually we define above RMB4,000 above. You will see fluctuation in the overall market month over month or among these three major carriers there, but overall that market itself it's still slow in growing in our view there.

So -- what we aim to gain -- our strategy is also very clear. We will continue on to gain market share in that domain and then we can come down grabbing market share in the RMB3,000, RMB2,000, RMB1,500 domain.

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**James Faucette** - *Pacific Crest - Analyst*

That's great. Thank you very much.

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**Peter Chou** - *HTC Corporation - CEO*

So our strategy is we want to have a good market share in high-end smartphones, especially in a market like China, I think, a less supplier [can't] enter into that segment. So HTC is one Company we are able to do this, so will continue to strengthen our position in that area. But of course, we would like to also leverage the brand awareness preference from some of our top product market and we also want to address some of the mid to affordable range of products. So we definitely don't want to limit ourselves in particular segment; however, we definitely want to make sure that we are a very strong player in high-end segment.

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**Operator**

Judy Chen, Harvest Global Investments.



**Judy Chen** - *Harvest Global Investments - Analyst*

I'm just wondering because you are looking for your cost -- you say your cost is very high and also in the third quarter your operating margin actually will be down to 0% to minus 8%, so -- Peter also mentioned about you probably need to ramp up the inventory, all these things.

I was just wondering, do you think about to reduce your cost, I mean, through like -- meaning you are outsourcing to some EMS to reduce your cost? (Inaudible) can do this I don't see why HTC cannot do it. Given you want to do it by yourself, but the products are delayed in the first quarter, so I really don't see any reasons you should try most your effort to reduce the cost at least -- I don't know if any possibility to reduce your cost through any -- lot of things?

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**Peter Chou** - *HTC Corporation - CEO*

Yes, of course, of course we are open minded and flexible to extra -- what is possible to improve our cost structure, but I think we are still hoping that we are actually getting breakeven or even better. But of course right now because of some of the aging inventory in channel, so we need to clean those things. So we are having a little bit conservative view at this stage.

But cost structure, cost is something quite complicated. I think there's many things involved. Today, I think the manufacturing cost is not our biggest challenge -- that is a comment I want to make here. We are actually quite efficient in terms of our manufacturing efficiencies.

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**Judy Chen** - *Harvest Global Investments - Analyst*

Okay. The other things, I think the -- I mean as it is you are putting more effort because (inaudible) more than 11 years now, I think the share price will affect the listing price, probably lower -- even lower. So I think you guys should put more effort to lead the Company, especially from the -- it's quite (inaudible) in the one quarter that we see the loss making. As always that probably just only one quarter, but it's not like kind of continually weak. We have seen, you know, suffering for a few quarters. I don't know you -- you've probably used more numbers than me, but I don't know if you can have a more strategy to push up your fundamental.

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**Peter Chou** - *HTC Corporation - CEO*

I think we are hoping that Q3 is our bottom, and we will see the improvement in Q4. And we are actually very confident of HTC brand and we are actually very excited and committed to continue to innovate, to create value, to stay competitive in the market. And we have some intangible core value, core asset. We believe they are very, very strong, but of course now market is very, very competitive and dynamic and then -- but we have to stay firm, and very focused and committed to be doing a good job what we needed to do. I think that's our current stand.

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**Judy Chen** - *Harvest Global Investments - Analyst*

I guess this Company, I mean (inaudible) Company that you do share buyback -- if this quarter, it's part?

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**Peter Chou** - *HTC Corporation - CEO*

Well, we would be open minded to consider what makes sense for us to do that.

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**Judy Chen** - *Harvest Global Investments - Analyst*

But you did this share buyback when share price was really high.



**Peter Chou** - *HTC Corporation - CEO*

Well, I cannot argue and talk with you about the share price in here.

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**Judy Chen** - *Harvest Global Investments - Analyst*

No, I know, but it's like, you just mentioned (inaudible) if you see this quarter (inaudible) and then do some share buyback, at least say that you want to do the -- encourage the employment to have some -- maybe it's (inaudible - multiple speakers) like this one, right? I think the last time when HTC conduct the share buyback (inaudible), I mean, I think the reason is the same -- it's the same reason that you want to buy shares to give those share, I mean, to employee, to encourage your [old employees], right?

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**Chialin Chang** - *HTC Corporation - CFO*

Yes, the -- as Peter mentioned, share repurchase will be one of the consideration. When it comes to share repurchasing there are a couple considerations when you do the share purchasing in terms of how you see the market there, in terms the -- reduce the valuation there. Obviously, when it comes to employee incentives, various ways of doing that here, buying back share, using the traded share for employee is just one of the options. There is (inaudible) we are actually doing that in terms of providing the employee incentive which actually we are just in the process of doing that.

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**Judy Chen** - *Harvest Global Investments - Analyst*

Okay. That's for me now. Thanks.

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**Chialin Chang** - *HTC Corporation - CFO*

Thank you.

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**Operator**

Robert Yen, Goldman Sachs.

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**Robert Yen** - *Goldman Sachs - Analyst*

I have three questions. First, HTC in the past two years has been doing these channel inventory exercise for several times. And I think I remember Chialin you said that now dealing with this channel inventory is not a very pleasant experience, and that you want to be quite prudent in the channel sell in to avoid any inventory problems. But still you still have to deal with the channel problems in the third quarter. I just wonder what's going on and how HTC can avoid these channel inventory problems again in the next few quarters.

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**Peter Chou** - *HTC Corporation - CEO*

Yes, Robert, we are a young Company in terms of brand, in terms of channel management execution. So we learn from our experience, and of course when we are younger and we go (inaudible) and tried and -- but I think that we have so far -- I think since early this year, end of last year, we really tried to control and manage our channels. And it also make us little suffer because in the past they pushed too much product there and also cost challenge of grey market that kind of things and -- but now, I believe we have established full capability to really managing those, and

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now we have a system and we are able to really closely watching what is the sell through, what is the sell in, what is (inaudible), where is our product going on.

So I believe we hope, okay, that this is a probably the last quarter that we have to deal with this kind of problem. So that's why we have decided that okay let's clean all these things one quarter.

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**Robert Yen** - *Goldman Sachs - Analyst*

All right. Thank you very much, Peter. Can you disclose which region has these inventory problems the most or --?

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**Peter Chou** - *HTC Corporation - CEO*

I am afraid we cannot disclose that detail.

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**Robert Yen** - *Goldman Sachs - Analyst*

No problem, no problem. My second question is on the China progress. Can you comment on the HTC China progress year to date? Is HTC growing faster or slower than the China market? If slower, what's the bottom max there?

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**Chialin Chang** - *HTC Corporation - CFO*

Robert, as we talk about there, we actually gained market share in the top end segment, and the top end segment as defined above RMB4,000. So as like some of local players think about top end is like RMB1,500 and above. So that to us is very important because continue establishing the brand, premium brand awareness and consideration is important in order for us to grab market share in a different price segment including RMB3,000, RMB2,000 and, RMB1,500 and that's number one.

Number two, as said in some of the press release we have there, we do see a intensified competition in some of the say between the RMB1,500 to RMB2,500 category, and sometimes it's around the neighborhood as well. And that we see more players providing the time to grab that part of the segment here, that we do see the competition. Obviously, we do have solution in anticipation for that and that's part of our mid-end product strategy as well as we go into later this quarter and into the rest of the year.

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**Peter Chou** - *HTC Corporation - CEO*

We are excited about China market because as I said, not many brands can play in this high-end market. Also I think (inaudible) China market is going to (inaudible) HTC is one of the very strong player in that opportunity, I think.

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**Robert Yen** - *Goldman Sachs - Analyst*

Thank you very much Peter and Chialin. My last question, I think it's also the question HTC shareholders want to ask because this is the first time HTC posted quarterly losses in many years. Thus, do you expect HTC to return to profitability very soon or let me put it this way, does management has any visibility when HTC can return to profitability? Now you don't have to give me specific time. I just want to know do you expect to return to profitability very soon or do you still think there is some time HTC needs to implement some strategies to return to profitability?



**Chialin Chang** - HTC Corporation - CFO

Robert, as Peter mentioned that we do hope and we think this is the bottom for the quarter in terms of profitability. We can't predict the future here, but we have quite a few actions in place we are addressing. So we do believe we can restore to profitability pretty soon.

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**Robert Yen** - Goldman Sachs - Analyst

That's all my questions. Thank you very much Peter and Chialin.

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**Chialin Chang** - HTC Corporation - CFO

Thank you.

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**Operator**

Anne Lee, Nomura.

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**Anne Lee** - Nomura - Analyst

If the third quarter's margin pressure some -- was impacted by some aging product issues, could you give us more details of whether -- how much of the portion is one off, and going forward, what kind of margin level is more sustainable in the [mid-tier]?

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**Chialin Chang** - HTC Corporation - CFO

So let me just clarify some of your questions there, and I just want to answer in a broad sense. Obviously, I wouldn't delve too much into in terms of cleaning channel inventory there. Obviously, that part of it is part of the gross margin. And if you look at our gross margin, yes, that's a few points down from the previous quarter in terms from the guidance perspective there, but if you look at how we guide the operating margin line there, it implies there is a cost structure in terms of operating the entity, in terms of operating expense there.

Obviously we are going to try very hard starting this quarter here to address those issues there. So the whole issue, not just a channel inventory part here, it's overall cost structure from the cost of goods sold side and also the operating expense side we are addressing, that's number one.

Coming specifically to your channel inventory issue there here, we are cleaning the pipe here and this is always a ongoing process. We don't expect the -- you have a huge amount every quarter in the third quarter. We just want to be clear that we have emptied the pipe, so we can prepare for the launch of mid-tier and [ranges] we talked about.

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**Anne Lee** - Nomura - Analyst

Okay. And then Peter mentioned some mid range products that is going to be launched by the end of this quarter. Could you give us some color whether how we -- well, how to differentiate our mid range product or entry level products versus the others. Just give us some color. We want to differentiate the functionality or the platform or how are we going to compete with the others.

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**Chialin Chang** - HTC Corporation - CFO

As always, HTC differentiated product through design innovation. The functionality -- it's more a user experience. The functionality is all embedded in those things in there. I think the functionality is just one aspect of it. So the design innovation experience, the overall package is what we care.

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And then you will see throughout the rest of the year here some of the good user experience we have -- discover the wonder in HTC One, we will see that throughout the rest of the year, some of our product there as well.

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**Anne Lee** - Nomura - Analyst

Okay. And the other thing is given we are suffering from the higher cost structure of the new one, will this change our phone cost strategies for future Hero products?

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**Peter Chou** - HTC Corporation - CEO

Well, it's hard to answer directly, but HTC has been a Company always trying to improve in probable way. I think definitely we will do everything for us to try to stay competitive.

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**Anne Lee** - Nomura - Analyst

Okay. Thank you.

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**Chialin Chang** - HTC Corporation - CFO

We accumulate a lot of experience, and I think the team is very knowledgeable going forward. So we will definitely leverage our experience to make us competitive in the market in the future.

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**Anne Lee** - Nomura - Analyst

Okay. Thank you. I have no more questions.

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**Operator**

(Operator Instructions) Jean-Louis, FTJL.

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**Jean-Louis Lafayeedney** - JI Asia - Analyst

I have a couple for you. The first one is just on the inventory side. I know we've talked about this a lot, but on your balance sheet it says TWD28 billion in terms of inventory. I would like to know how close is that to the real amount and in fact within the -- what does that represent versus what is actually in the channel. Thanks.

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**Chialin Chang** - HTC Corporation - CFO

Obviously, the in-house material inventory versus the channel inventory, and there are two different things here. The TWD28 billion is still slightly higher, but actually coming close to our quarter normal if you look -- if you had a chance to look at the just say last 10 quarters. So we want to continue to optimize a little bit by getting to the level where we think it's the level is good. And in terms of compared to the channel inventory, well I think we are comparing different things. We are comparing the materials inventory versus the finished product inventory; they are two different things there.

**Jean-Louis Lafayeedney** - *Jl Asia - Analyst*

Okay. I understand. I am just trying to ascertain, I guess, you haven't answered this in the previous question, but trying to ascertain if you know how much there is in the channel?

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**Chialin Chang** - *HTC Corporation - CFO*

Well, if we know how much inventory in the channel, of course we do how much -- we know how much inventory in the channel in terms of the number of units.

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**Jean-Louis Lafayeedney** - *Jl Asia - Analyst*

Can you tell us?

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**Chialin Chang** - *HTC Corporation - CFO*

No, I cannot tell you of course, for obviously competitive reasons here, but we do know. That's how we manage our inventory in terms of the sell in, the sell through, and the warehouse and also down in the retail points. We need to have a certain -- we can't say we have 100% control, but we do have certain knowledge, pretty good knowledge in where our goods are, which is important.

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**Jean-Louis Lafayeedney** - *Jl Asia - Analyst*

All right, let me ask you a second question if I may. The launch of HTC One this year, I mean, you had it -- I think it was about 185 operators if I remember correctly, the [Airtel] phone is terrific, but [iSuppli] said that it may have the most expensive bill of materials of any phone ever produced. And I guess here with your HTC One released in 2013 was a bit of a gamble effectively that did not pay off as far as I can see because we have one quarter of positive momentum in sales. So it looks like a snapshot of the same point last year when the One X was released, had one quarter of momentum and then died again. So my question is here what do you do -- do you do the same thing again, do you wait another 12 months, come out with another flagship. By that point, smartphone sales in the top end will be -- there will be less momentum in general. There will be less top-end smartphones sold globally, most likely.

So from what I've heard so far in this call, are you saying that your strategy now going forward is to change and it is to become a mid-end to low-end player and try and get volume in order to hit scale in markets where you already have a certain market share? Is that the strategy going forward?

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**Peter Chou** - *HTC Corporation - CEO*

I want to correct you that HTC One is not just pump out and die. HTC One momentum continues to stay very, very strong, and we are very committed to continue to push HTC One. I mean, the overall study in every market is still quite well, so I want to correct you about this is different from last year.

Of course, some of the challenge we have this quarter is the mid-end market share. So that's what we are addressing those mid-end product to get more market share, that's what we're doing.

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**Chialin Chang** - *HTC Corporation - CFO*

Just to add on to that question, if you look at some of the players, look at the market here you have a complete product portfolio here. In that complete product portfolio your super phone category will be a portion of the product portfolio here. And we believe that percentage is -- we're not at that percentage level so we want to be that percentage level. By doing that we need to increase our mid to affordable end volume there.

**Peter Chou** - *HTC Corporation - CEO*

Yes. For example we're excited to see the HTC One Mini response from market so far. So we expect HTC One Mini would do quite well, and we have more mid-tier product coming later. So I think these product portfolio will help us to return momentum.

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**Jean-Louis Lafayeedney** - *Jl Asia - Analyst*

Okay. Well, let me just ask one final simple question. Do you expect your units of phones, smartphones sold this year, to beat last year or to underperform compared to last year?

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**Chialin Chang** - *HTC Corporation - CFO*

We started in the beginning, this is the -- July, still we have five months to go, so I think it's probably not appropriate to comment in that regard.

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**Jean-Louis Lafayeedney** - *Jl Asia - Analyst*

All right. Thank you.

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**Chialin Chang** - *HTC Corporation - CFO*

Thanks.

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**Operator**

John Lopez, Vertical.

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**John Lopez** - *Vertical - Analyst*

I had a couple of quick ones that I think are probably more extension to the prior series of questions. So I apologize it's a little redundant, but if you could return to the balance sheet inventory for a second, leaving the channel aside. As you noted, the TWD28 billion, I guess it's in the range of where nominally your inventory has been, but obviously your revenues are back to where they were at the very beginning of 2010. So I guess my question is why does it make sense to have inventory higher year-on-year when revenues quite clearly aren't? What's the delta between those two that requires you have higher inventory with lower units and lower revenues?

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**Chialin Chang** - *HTC Corporation - CFO*

To answer your question most of the inventory, actually are the components and material inventory. And some of the key components require a long lead time, and sometimes a bulk purchase will give you a better pricing. Obviously, the better economies of scale will give you further better advantage on pricing there. So some of these considerations will have a higher inventory.

And then we talked about it last time, just now, that we're not at the level we want to be yet, but we're close to the level here so we continue performance, we go down to the level where we think it's good for us. And obviously we're looking at the inventory level versus our sales momentum as well, so that basically is the gist of it.

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**John Lopez** - Vertical - Analyst

Okay, understood. Second question, I'm sorry, I know you talked about this a little bit, but maybe if you could just try answer this directly, in terms of the margin improvement that you're contemplating into calendar Q4, is it your expectation specifically that component prices will be lower between calendar Q3 and calendar Q4. I'm a little unclear as to what would drive a margin improvement absent that, and I'm just -- I want to make sure that that's what you're attempting to communicate?

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**Chialin Chang** - HTC Corporation - CFO

Yes, I think the -- if you talk about a gross margin improvement, yes, part of it coming from the bill of material improvement. I won't comment specifically on the specific component there. We do anticipate and we do believe we can drive further optimization on the bill of material cost for devices. And there is other part of the cost improvement we talk about from the operating perspective.

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**John Lopez** - Vertical - Analyst

Okay. Thanks for that. The next question, and I guess we've asked you a sort of strategic perhaps, but I'm looking to get some numerical specifics. Your revenue performance in Q2 obviously related by some channel sale and the HTC One, but if I look at the sales and marketing, you increased your sales and marketing in dollars by 162% sequentially which looks to be the biggest sequential increase in sales and marketing ever or many, many years. So on the one hand you obviously increased revenues but you had to spend a lot to do so.

This appears to be endemic to the industry at this point, and so I'm just wondering if you talk strategically as to how you break that chain. In other words, you can generate revenue but you have to spend materially on sales and marketing to do so, and if you pull that back the revenues appear to decline pretty precipitously. So how do you undo that cycle, for lack of a better term?

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**Peter Chou** - HTC Corporation - CEO

Well, we as a Company, we don't want us to be shortsighted. So we want to make sure that we invest for our future as well. So we're committed actually to invest in our brand, in talent, and innovation. So but of course, we would try to balance as much as we can both for short-term and for long-term.

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**John Lopez** - Vertical - Analyst

Okay. Well, if I could ask that just differently, sales and marketing was 15% of your revenues which is again a multi-year high. Is it anticipated to remain -- obviously, the operating expenses are going to be elevated given the guidance for Q3, but is this right around the nominal level that this line item will remain prospectively?

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**Chialin Chang** - HTC Corporation - CFO

No, it will not be the nominal level going forward on a long-term sustainable basis here, long-term sustainable obviously we have a bench, but in terms of percentage we have, probably not proper to disclose it here, and then we have some variation we can adjust in there.

I don't -- I would want to comment on what you say here though. I don't believe there is a very, it's not a tie in terms, because the revenue -- you have to remember, revenue is here in terms -- the P&L revenue is a selling revenue. The sales and marketing effort you put in here is to improving -- it's not improving, it's actually facilitate your sale. You want to create a momentum. It is very important when you start launching a product the initial momentum out of the gate has to be strong, and then the various ways to continue to sustain that kind of momentum there.



We do recognize in terms of sales and marketing has to be sometimes -- it has to be in the end in a normal period tied into your sales momentum. So that's something we fundamentally are addressing it. In addition to that, we're also looking into the whole efficiency/effectiveness on the whole, the resources that we put in there as well.

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**John Lopez** - Vertical - Analyst

Okay. So, the last one, I just want to touch on something you raised earlier and just to get your thoughts on it which is, you referenced the market sort of broadly that is -- I can't remember the exact words you used, but something along the lines of confused, maybe another word I would use is cluttered.

You have a lot of smartphones that are launched with very short intervals between the launches, and then the strategy now appears to be to launch a flagship model and then fairly quickly a follow-up lower-cost version of the same family; we're seeing this across your peers as well. At the same time obviously revenues are not keeping pace and -- as your guidance implies.

So I guess my question is, strategically, is this the right approach. In other words, it just feels like there is a device launch, there is a lukewarm reception, and it's quickly followed with another device launch behind it. And is it perhaps that the market is just getting too crowded and confused with the constant barrage of products such that perhaps widening the periodicity would be beneficial. I just hope that you could speak for a minute about that broadly because it just seems like the trend at the moment of really short product launches followed closely together isn't having the desired effect.

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**Peter Chou** - HTC Corporation - CEO

Well, you're right. I think it does require conscious decision in how to balance those. I remember that 2011 people complained that HTC has too much product, so it actually confused the market and people confused. So we're a little more balanced control now to see how we sustain our product and how we manage.

So there is no right or wrong answer, I believe, but we see some company, they are still doing that type of stuff. And of course, we also saw that they confuse the market. And I think that it's individual company's decision. I think we don't want to comment which one is the right or wrong, I think it's really conscious experience and decision to how you manage your portfolio.

For us, I think it is extremely important to stay focused, to make sure that people think HTC One is one of the best designs, and the kind of the product image, brand image we think is so important.

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**John Lopez** - Vertical - Analyst

Understood. Thanks for all your help.

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**Peter Chou** - HTC Corporation - CEO

Thank you.

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**Chialin Chang** - HTC Corporation - CFO

Thank you.

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**Operator**

Alban Cousin, Arete Research.

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**Alban Cousin** - *Arete Research - Analyst*

Thanks. My question has been answered. Hello.

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**Peter Chou** - *HTC Corporation - CEO*

Yes.

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**Alban Cousin** - *Arete Research - Analyst*

Yes, sorry. My question has been answered already. Sorry.

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**Chialin Chang** - *HTC Corporation - CFO*

Thank you.

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**Operator**

There is currently no question in line. I will pass the call back to CEO Mr. Chou for closing remarks. Mr. Chou, please go ahead.

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**Christine Chi** - *HTC Corporation - IR Manager*

Okay. This will end the second quarter result meeting, and thank you very much everybody for joining. Thanks.

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**Chialin Chang** - *HTC Corporation - CFO*

Thank you.

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**Operator**

Thank you for your participation in HTC's conference call. There will be a webcast replay within an hour. Please visit [www.htc.com](http://www.htc.com) under the Investors section. You may now disconnect. Goodbye.

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