

YOUDAO 2Q 2023 CONFERENCE CALL SCRIPT

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Operator introduction

Good day and welcome to the Youdao 2023 second quarter earnings conference call. Today's conference is being recorded. At this time, I would like to turn the conference over to Mr. Jeffrey Wang, investor relations director of Youdao. Please go ahead.

Jeffrey Wang

Thank you, operator. Please note the discussion today will contain forward-looking statements, related to future performance of the Company, which are intended to qualify for the Safe Harbor from liability, as established by the U.S. Private Securities Litigation Reform Act. Such statements are not guarantees of the future performance and are subject to certain risks and uncertainties, assumptions and other factors. Some of these risks are beyond the Company's control, and could cause actual results to differ materially from those mentioned in today's press release and this discussion.

A general discussion of the risk factors that could affect Youdao's business and financial results is included in certain filings of the Company with the U.S. Securities and Exchange Commission. The Company does not undertake any obligation to update this forward-looking information, except as required by law.

During today's call, management will also discuss certain non-GAAP financial measures, for comparison purposes only. For the definitions of non-GAAP financial measures, and reconciliations of GAAP to non-GAAP financial results, please see the 2023 second quarter financial results news release issued earlier today.

As a reminder, this conference is being recorded. Besides, a webcast replay of this conference call will be available on Youdao's corporate website at ir.youdao.com. Joining us today on the call from Youdao's senior management is Dr. Feng Zhou, our Chief Executive Officer, Mr. Lei Jin, our President, Mr. Peng Su, our VP of Strategy and Capital Markets and Mr. Wayne Li, our VP of Finance. I will now turn the call over to Dr. Zhou to review some of our recent highlights and strategic direction.

Feng Zhou

Thank you, Jeffrey. And thank you all for participating in today's call. Before we begin, I would like to remind everyone that the financial information and non-GAAP financial information mentioned in this release is presented on a continuing operations basis, and all numbers are based on Renminbi, unless otherwise specifically stated.

In Q2 2023, our net revenues came in strong and reached RMB1.2 billion, representing a year-over-year increase of 26.2%. Loss from operations narrowed to RMB289.1 million, marking a year-over-year improvement of 36.5%. Net cash provided by continuing operating activities stood at RMB133 million, reflecting growth of 27.6% year-over-year. We are on a clear path to achieving profitability. As for our business segments, learning services and online marketing services continue to be our current main driver of growth, both reaching record levels of sales. In the meantime, we are making solid progress in learning devices R&D, and we are leading the charge to apply AIGC in education by rapidly releasing applications of generative AI.

In the first half of the year, we see an overall positive trend in key financial indicators. Net revenues amounted to RMB2.4 billion, indicating an increase of 9.9% year-over-year. Loss from operations in the first half reduced to RMB484.9 million, improving 16.4% year-over-year. Net cash used in continuing operating activities reached RMB304 million, marking a 5.4% year-over-year improvement.

For our learning services segment, Q2 sales of digital content exceeded RMB800 million, reaching a record high. Customer retention rate across these services was over 60%, leading to over RMB200 million in operating cash inflow for this area. In addition to our learning content, we launched an AI University Application Adviser (AI 志愿填报系统) in Q2 to support students in their college selection process. Users were quick to adopt this tool, leading to over 2 million page views.

Online marketing services maintained the rapid growth momentum from the last two quarters. Net revenues reached RMB303.6 million in Q2, a historical high, representing an increase of 98.7% year-over-year. Moreover, gross profit margin improved by 4.2 percentage points year-over-year. These achievements were primarily due to advancements to our ad platform driven by AI algorithms. First, we used proprietary AI technology to effectively identify and track the topics and products matching the audiences of specific Key Opinion Leaders (KOLs), with accuracy rates approaching 90%, resulting in more precise ad placement. Second, AIGC not only reduced the time for producing ad materials by more than 80%, which drove better user

satisfaction, but also reduced production costs for certain ad materials by over 90%, driving the improvement in gross margin.

The positive trend in digital content services and online marketing services in Q2 is expected to continue in the second half.

Regarding STEAM courses, on the policy front, the Ministry of Education announced that starting from June 20th this year, primary and secondary schools will add new programming courses to their curriculum. This new policy is expected to further expand the demand for programming content and services from families. Youdao recently hosted the 7th “Wisdom Cup” Computer Programming Contest for primary and secondary school students in Beijing’s Haidian District in Q2, which showcased Youdao’s influence in the field of programming. In addition, both programming and Go courses performed well with retention in Q2, with the retention rate for the advanced classes approaching 70%. Besides, a student from the champion class won the Go Championship at Jiangsu Mind Sports Games.

In terms of smart devices, total revenues of smart devices were down by 7.4% in Q2 year-over-year. We are still in a transitional period for device business, mostly due to sluggish consumer spending in recent months and our stricter sales & marketing budget control. Both Youdao Dictionary Pen and Youdao Listening Pod performed well during the June 18th Shopping Festival, topping the chart for four consecutive years and two consecutive years respectively on JD.com for both sales volume and number of units sold in its category. In addition, Youdao Listening Pod was updated to support Youdao Learning OS, featuring additional apps such as “Chinese Children’s Encyclopedia” “Collins Big Cat Reading” and “Youdao AI Listening,” further enriching users’ experience. More recently, in August, we released Youdao Dictionary Pen X6 Pro and Youdao Listening Pod Pro. We believe in the long-term prospect of learning devices as they are convenient, helpful and affordable for consumers. We are focusing on two things to drive growth and profitability. One is new products, which we will have more in Q4. And second is optimization to our marketing and sales, which is under way.

Then let’s discuss our progress with AI. As a leading education technology provider in China, we have always been proud of our capabilities in technological innovations. We believe large language models and AIGC presented a great innovation and growth opportunity for us. In July we announced our proprietary large language model Ziyue optimized for education applications, and have successfully deployed it in six applications starting from the second quarter.

We believe we are among the fastest in adopting LLM and making the most solid business progress in this area in China. I am happy to report that one of Ziyue's applications, the AIBox feature in Youdao Translation, has already driven nearly 100% year-over-year growth of translation subscription, and over 200% year-over-year growth of subscription fees. AIBox provides very convenient, in-application AI features like sentence refinement, grammar correction, writing suggestion, and summarization.

In July, we also launched the first digital human language coach in China named Echo. Echo teaches spoken English one-on-one. And thanks to large language models, she understands the learner very well, is fun to talk to, and provides high-quality feedback that really helps the learners improve their language acquisition. Echo made its debut at the World Artificial Intelligence Conference in Shanghai, receiving great enthusiasm from the audience and media. Two weeks ago, Echo became generally available in Youdao Dictionary Pen X6 Pro. The reviews so far are great and we expect Echo and more AIGC launches to drive our business growth in the coming months.

Looking ahead, we believe education could be among the top verticals for large language models. This technology provides great potential for personalization of the learning experience, effective guidance throughout the learning process, and integration of knowledge across subjects.

That summarizes our business operations in Q2.

At a high level, our strategy this year is two-fold. Firstly, we prioritize driving healthy growth by offering high quality digital content services. Secondly, we dedicate efforts to accelerate the integration of generative AI into our products and services. In Q2 our teams made significant progress in both areas. The user demand for high-quality learning products and services remains consistently high. Leveraging our strengths in content creation, user understanding, and technological capabilities, we are committed to continuously delivering exceptional products that address the needs of our users.

Finally, I would like to share Youdao and the NetEase Group have both approved a proposed amendment to the aforementioned US\$300 million revolving loan facility to extend the maturity date of the facility, including the loans already drawn from it, until March 31, 2027. In addition, we announced that the board of directors has approved an amendment to the foregoing program to increase the total authorized repurchase amount by an additional US\$20.0

million. These demonstrate the long-term support from NetEase and the confidence from Youdao's management.

Thank you. And now is Peng Su to give you an update on our financials.

Peng Su

Thank you, Dr. Zhou, and hello everyone.

Today I will be presenting some financial highlights from the second quarter of 2023. We encourage you to read through our press release issued earlier today for further details.

For the second quarter, total net revenues were RMB1.2 billion, or US\$ 166.4 million, representing a 26.2% increase from the same period in 2022.

- Net revenues from our learning services were RMB680.9 million, or US\$ 93.9 million, representing a 20.8% increase from the same period in 2022, primarily driven by the strong sales performance of digital content services compared with the same period of 2022.
- Net revenues from our smart devices were RMB222.2 million, or US\$ 30.6 million, down 7.4% from the same period in 2022, primarily due to the decreased demands for intelligent learning products in the second quarter of 2023.
- Net revenues from our online marketing services were RMB303.6 million, or US\$ 41.9 million, representing a 98.7% increase from the same period in 2022. The increase was mainly attributable to the increased demands for performance-based advertisements through third parties' internet properties.

For the second quarter, our total gross profit was RMB567.2 million, or US\$ 78.2 million, representing a 38.4% increase from the second quarter of 2022.

- Gross margin for learning services was 57.4% for the second quarter of 2023, compared with 52.2% for the same period in 2022.
- Gross margin for smart devices was 35.8% for the second quarter of 2023, compared with 30.6% for the same period in 2022.
- Gross margin for online marketing services was 31.9% for the second quarter of 2023, compared with 27.7% for the same period in 2022.

For the second quarter, total operating expenses were RMB856.3 million, or US\$ 118.1 million, compared with RMB864.9 million for the same period of last year.

With that, for the second quarter, our:

- Sales and marketing expenses were RMB587.7 million, compared with RMB596 million in the second quarter of 2022.
- Research and development expenses were RMB205.1 million, compared with RMB208.4 million in the second quarter of 2022.

Our operating loss margin was 24% in the second quarter of 2023, compared with 47.6% for the same period of last year.

For the second quarter of 2023, our net loss from continuing operations attributable to ordinary shareholders was RMB299.2 million, or US\$ 41.3 million, compared with RMB453.9 million for the same period of last year. Non-GAAP net loss from continuing operations attributable to ordinary shareholders for the second quarter was RMB283.6 million, or US\$ 39.1 million, compared with RMB435.8 million for the same period of last year.

Basic and diluted net loss from continuing operations per ADS attributable to ordinary shareholders for the second quarter of 2023 was RMB2.45, or US\$ 0.34. Non-GAAP basic and diluted net loss from continuing operations per ADS attributable to ordinary shareholders for the second quarter was RMB2.32, or US\$ 0.32.

Our net cash provided by continuing operating activities was RMB133 million, or US\$ 18.3 million, for the second quarter.

Looking at our balance sheet, as of June 30, 2023, our contract liabilities, which mainly consist of deferred revenues generated from our learning services, were RMB1.2 billion, or US\$ 167.3 million, compared with RMB1.1 billion as of December 31, 2022. At the end of the period, our cash, cash equivalents, restricted cash, time deposits, and short-term investments totaled RMB680 million, or US\$ 93.8 million.

This concludes our prepared remarks. Thank you for your attention. We would now like to open the call to your questions.

Jeffrey Wang

Thank you once again for joining us today. If you have any further questions, please feel free to contact us at Youdao directly, or reach out to Piacente Financial Communications in China or the US. Have a great day.