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NHTC - Q2 2017 Natural Health Trends Corp Earnings Call

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PRESENTATION

Operator

Greetings, and welcome to the Natural Health Trends Corporation Second Quarter 2017 Earnings Conference Call. (Operator Instructions) As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, Kimberly Orlando of ADDO Investor Relations. Thank you, Ms. Orlando. You may begin.

Kimberly Orlando - *ADDO Investor Relations - SVP*

Thank you, and welcome to Natural Health Trends Second Quarter 2017 Earnings Conference Call. During today's call, there may be statements made relating to the future results of the company that are forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995. Actual results, performance, or achievements could differ materially from those anticipated in such forward-looking statements due to the result of certain factors, including those set forth in the company's filings with the Securities and Exchange Commission.

It should also be noted that today's call will be webcast live and can be found on the Investor section of the company's corporate website at www.naturalhealthtrendscorp.com. Additionally, in today's financial results press release, which was issued at approximately 9:00 a.m. Eastern time, instructions can be found for accessing the archived version of the conference call via the Internet.

At this time, I'd like to turn the call over to Chris Sharng, President of Natural Health Trends.

Chris T. Sharng - *Natural Health Trends Corp. - CEO, President and Director*

Thank you, Kim, and thanks to everyone for joining us. With me today is Scott Davidson, our Senior Vice President and Chief Financial Officer. Total revenue for the second quarter of $51.5 million declined by 36% from the second quarter of 2016, and by 14% from the first quarter of 2017. The decline versus the prior quarter can be traced to the slowdown we have been experiencing in our Asian markets since the third quarter of 2016. For those members, including many leaders that joined us after 2011, this is the first time they are learning how to manage through an environment characterized by slower momentum. It is a necessary step for the company's long-term development. Importantly, we have been able to retain all of our top ranked leaders since the slowdown began. We're also actively working to reinvigorate our sales force. Our top leaders have been with NHT Global from our early years and morale remains very positive. We're supporting the leaders by working with their groups on an individual basis, as each group has to deal with different dynamics and different areas to improve. I will elaborate more on this in a moment.

The second quarter of 2016 also presented a challenging year-over-year comparison as we implemented a significant product price increase for our top-selling product, Premium Noni Juice, effective last June. The price increase pulled demand forward into the second quarter of last year. Also, similar to previous quarters, we continue to face currency headwinds as the stronger Hong Kong dollar made our products effectively more expensive for our Chinese consumers. Partially offsetting the year-over-year decrease in net sales was strength in Europe, our market opening in Peru and a positive response to our most recent product introductions. Further, we were able to maintain a strong growth profit margin of 81%. Our operating income margin was also very strong at 25% compared to the 18.6% in the prior year quarter. We've been able to maintain our gross profit margin and expand our operating income margin primarily due to proactive expense management to better align our cost structure with a more limited upside opportunities we have been seeing in the field.

We're working to reinvigorate momentum in Asia by enhancing our incentive programs and adjusting our bonus and reward programs to give more resources to the most productive and up-and-coming members. We recently announced enhancements to our matching bonus program, encouraging our top leaders to assist their down-line members to start earning commissions. Further, we announced a modification to our recognition program by easing the qualification criteria for rank advancement. Instead of basing it on performance for 2 consecutive months in any given quarter, members now can qualify for a rank advancement in any 2 consecutive months throughout the year.

We held 2 incentive trips during the quarter. Our Fly High training held in Southwest China was our largest Chinese incentive trip ever, with more than 1,600 members in attendance. In May, we also held the first of 2 2017 international incentive trips to Dubai in which we hosted over 200 members. While these 2 events did not generate the same level of net sales as our larger incentive trips to New Zealand last year, the trips were well attended and supported by our leaders. We believe, these trips are good for team building and will spur incremental product orders in the coming months. In addition, we started a new incentive trip promotion to South Africa. The qualification period began in the third quarter of 2017, and will run through the second quarter of 2018.

Looking at geographical expansion. We celebrated our grand opening in Peru 2 weeks ago. The kick-off event and office ribbon cutting ceremony were our first on the ground activities in this market. And we were very pleased to have more than 600 Peruvian members participate. In June, we began taking orders and started shipping. Orders in the second quarter totaled almost $0.5 million. In Malaysia, we recently received preliminary approval for direct selling license. This is a significant milestone that will allow us to extend our member base into this promising market. The timing also correlates with our major summer event held in Kuala Lumpur, slated for later this month. We expect a 2-day celebration, which marks the official opening of our business in Malaysia to attract roughly 6,000, mostly Chinese, attendees, with the goal of implementing successful product trainings, member recognition and new product launches.

Turning to Europe. Our European leaders sponsored a 4-city tour during the quarter, in Oslo, Gothenburg, Helsinki and Dublin, although still a small percentage of our overall sales, we have continued to experience triple-digit growth in our European market.

We have been nurturing a growing group of members on the East Coast of United States, especially in the tri-state area. To support them, we are planning for a third North American Healthy Lifestyle Center Plus or HLC Plus. As a reminder, HLC Plus serves as multifunctional retail spaces, designed to provide members with the opportunity to personally experience our products as well as a place to conduct meetings. We expect the new HLC Plus will be located in Metuchen, New Jersey, and anticipate it will be fully functioning by early 2018.

Despite the various expansion initiatives underway, China remains our top priority. We are still in the process with our application for direct selling license. However, the timing of obtaining the license and whether or not, we can obtain one, remains beyond our control. We will provide updates as material developments arise.

Another highlight during the quarter with respect to the Chinese market has to do with a receipt of approval to process payments through WeChat, the biggest Chinese social networking and mobile payment application and UnionPay, the dominant credit card processor in China. This will facilitate product sales moving forward.

Lastly, I like to comment on our capital allocation. We generated $6.8 million in cash flow from operations during the quarter. We will continue to return cash to our valued stockholders as evidenced by our regular quarterly dividends and various special dividends. This is made possible by our strong balance sheet and working capital management.

While it will take time to restore our Asian markets to growth and to train our leaders to navigate the challenges involved in operating through a slowdown, we believe the measures we have taken to enhance our matching bonus and ease rank advancement among many other programs already in place, will attract, motivate and retain a strong member base.

With that, I'd like to turn the call over to Scott Davidson, our CFO to discuss our second quarter financials in detail. Scott?

Timothy Scott Davidson - *Natural Health Trends Corp. - CFO, Chief Compliance Officer, SVP and Secretary*

Thank you, Chris. As discussed, total revenue for the second quarter was $51.5 million, reflecting a decrease of 36% compared to $80.4 million in the second quarter of 2016. Sales in Hong Kong, which accounted for 89% of our second quarter revenue, decreased 38% year-over-year to $45.7 million. Outside of Hong Kong, revenue decreased 18% year-over-year to $5.8 million and was partly mitigated by a increase in Europe of 256% year-over-year. Our Active Member base declined slightly to approximately 107,000 at June 30 from 114,000 at March 31, and from 126,000 at June 30 last year.

In regard to our cost and operating expenses. Our gross profit margin for the second quarter was 81%, compared to 81.3% in the second quarter last year. This slight reduction was -- due primarily to lower event revenue this year, offset by reduced shipping cost. Commissions expense as a percent of total revenue decreased to 42.9% from 47.1% in the second quarter last year. This is still roughly in line with our full year 2016 rate of 43.5%. Selling, general and administrative expenses for the quarter decreased 47% to $6.6 million versus $12.4 million a year ago. The decrease in both commissions expense and SG&A versus the prior year period reflects the continued effectiveness of the cost reduction measures we implemented in the fourth quarter last year.

Operating income for the quarter totaled $12.9 million, a decrease of 14% compared to $14.9 million in the second quarter last year. However, as a percentage of total revenue, our operating income margin expanded to 25% compared to 18.6% in the second quarter last year.

We continued to recognize a income tax provision for the expected partial repatriation of overseas profits, resulting in an effective tax rate of 20% for the second quarter compared to 18% in the prior year period. Net income totaled $10.3 million or $0.91 per diluted share, as compared to net income of $12.2 million or $1.07 per diluted share in the second quarter last year.

Turning to our balance sheet and cash flows. Cash and cash equivalents as of June 30, 2017, were $136.3 million, which was up slightly from $134.7 million at March 31. During the quarter, we paid dividends amounting to $5.1 million. On July 31, our Board of Directors declared a quarterly cash dividend of $0.11 per share as well as a special cash dividend of $0.25 per share, both of which will be payable on August 31, 2017, to stockholders of record as of August 21.

That concludes our prepared remarks. I would now like to turn the call back over to the operator to begin the question-and-answer session. Operator?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of [Perry Anderson], a private investor.

Unidentified Participant

In prior calls, you mentioned that, the Macau event was moved down from January to March, but judging from the second quarter results, it's not obvious that there is any benefit in making that change. So what happened? Also, why was the incentive trips this year not generating as much sales as last year?

Chris T. Sharng - *Natural Health Trends Corp. - CEO, President and Director*

Good morning to you, Perry, and thank you for calling in. We think that what has impacted the effect or the sales effect of the Macau event in our incentive trips in the quarter, in the first half were also due to the larger forces at work that we have identified and that includes the slowdown we experienced and product price increase that was implemented a year ago and also, the currency exchange. We've been doing analysis on factors that might be specific to how the event and the incentive trip were planned and implemented. And although, the background is that, we always have 2 events - 2 major events during the year, one in the first half and one in the second half. The one in the first half over the years, we tended to do the event in January. And these events were driven by our greater Chinese markets, and we like to get that event implemented before the Chinese New Year. And after this year's experience, when we hosted a event in Macau in March, after the Chinese New Year, we do like the date to be after the Chinese New Year as the number of attendees have by far the biggest on our record as more than 5,000 people attended. It's easier to travel. It's easier for them to come to Macau. And also, we were able to generate some sales orders and we have no back orders. And back orders are not for good business and also it will create other complications. But indeed, I acknowledge that our Macau event did not convert as much as we expected in terms of sales orders. And we are a lot smarter in hindsight, and as we analyze the effect of the Macau event, we're trying to evaluate whether our content in the presentation was becoming stale or not as interesting. And also, we think that, Macau has become a much more attractive destination and maybe becomes a distraction. And we will be more cautious in picking Macau for our future events. We did have number of people that needed to be accommodated and it wasn't so easy to find a location with shorter notice in Macau or Hong Kong. But that would be something that we have learned from this experience. And the domestic incentive trip in China, in this location called Guilin, was meant for team building and for training. So we think that there are other benefits involved. And Dubai, was a smaller trip. And a year ago, when we planned for the incentive trip, we broke the qualification down into 2 trips. So we have in the first half a trip in Dubai by choice. And then the other qualified members will go to Japan on a cruise, in the second half. And with Dubai and Japan combined, it will be more comparable to the very large incentive trip to New Zealand a year ago. So we're still hoping that, there are benefits coming up in the second half, in September, specifically that we will have our Chinese members, 700 or 800 of them that will go to Japan. We hope that we will have some benefits coming out of that and to be more comparable to New Zealand.

Operator

Our next lesson comes from the line of [Jeff Lund], a private investor.

Unidentified Participant

This is [Jeff Lund]. You mentioned your total member count was down for the quarter. But that you've retained all your top leaders. Why you think there's been a decline? And do you have any insight on where those members went?

Chris T. Sharng - *Natural Health Trends Corp. - CEO, President and Director*

Okay. Good morning to you, Jeff, and thank you for calling in. And indeed, we acknowledge that, we have a total distributor count decreased. And as of now, not all but most of our members and leaders have joined us since 2011. And even for the members that joined us before 2011, it's common that they have sampled our products. They have some good results with our products. And maybe in the beginning, they liked to be a consumer, but after a while they join the business and like to make a business out of it. And so for these members and leaders, they joined the business side of our organization since 2011. They have been able to increase their commission income in many cases, substantially and quickly. This one direction -- one dimension kind of development has been a wonderful experience for many of them. But this started to change about 9 months ago. It's a new environment for most of these people. Even though this is a new setup, however, much uneasy we feel, we think that, this is a normal and necessary step -- a necessary experience for the company's long-term growth. And in China, most of our members are organized by informal groups. They call these groups clubs. And the groups continue to proliferate, evolve, and we have by now, hundreds of groups. The individual groups experience throughout the process is very different as well. Some groups, especially in Central China, continue to grow despite the overall numbers, but indeed, as you notice, and some members have left, and when they left most likely, they were not as successful as they would like or they have experienced in the recent past, and they probably don't put as much effort into it. Some of them they went to some other peer companies, and our typical competition would be small Chinese companies. And I think that process will play themselves out. And attrition also is a normal part of the business as well. I think right now, what we need to do is to focus on training and focus on good customer services to continue to do our core competency and that will increase our success over the long-term in growing the business. Thank you, Jeff.

Operator

That is all the time we have for questions. This does conclude today's teleconference. Thank you for your participation. You may disconnect your lines at this time, and have a wonderful day.