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Q2 2022 360 DigiTech Inc Earnings Call

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the 360 DigiTech Second Quarter 2022 Earning Conference Call.

Please also note today's event is being recorded. At this time, I would like to turn the conference call over to Ms. Mandy Dong, IR Director.

Please go ahead, Mandy.

Mandy Dong ***IR Director***

Thank you. Hello, everyone, and welcome to our second quarter 2022 earnings conference call. Our results were issued earlier today and can be found on our IR website.

Joining me today are Mr. Wu Haisheng, our CEO and director; Mr. Alex Xu, our CFO and director; and Mr. Zheng Yan, our CRO.

Before we begin the prepared remarks, I'd like to remind you of our safe harbor statements in our earnings press release, which also applies to this call. We may refer to forward-looking statements based on our current plans, estimates and projections. Also this call includes discussions of certain non-GAAP measures. Please refer to our earnings release for a reconciliation between non-GAAP and GAAP ones. Last, unless otherwise stated, our figures mentioned are in RMB.

I will now turn the call over to our CEO, Mr. Wu Haisheng.

Haisheng Wu ***360 DigiTech, Inc. - CEO & Director***

(foreign language)

Mandy Dong ***IR Director***

[Interpreted] Hello, everyone. I'm very happy to report another strong quarter. In Q2, total loan origination and facilitation volume reached RMB 98.3 billion, up 11% Y-o-Y. Outstanding loan balance reached RMB 150.5 billion, up 28% Y-o-Y. Despite an unusually volatile macro environment with the Shanghai lockdowns and resurgence of COVID in multiple cities, we delivered a solid performance, which once again demonstrated the resilience of our operations and risk management capabilities facing adversity.

Haisheng Wu ***360 DigiTech, Inc. - CEO & Director***

(foreign language)

Mandy Dong ***IR Director***

[Interpreted] On the regulatory front, there are further developments in rectification work of platform economy. The recent regulatory meetings have all sent a clear signal that the reform is reaching an ending phase. Going forward, regulators will put emphasis on driving healthy and sustainable industry development through normalized supervision. As the regulatory environment gradually stabilize, we see clearer guidance.

On July 28, the central political bureau of the Communist Party of China set out economic priorities for the second half of the year. The policymakers pledged to promote healthy, orderly development of the platform economy, complete the rectification work, and conduct regular supervision. At a follow-up meeting by the PBOC on August 1, the central bank remarked "Significant progress of major platform rectification", and it will "urge these companies to complete the whole rectification project, place them under regular supervision that is more standardized, transparent and predictable." As a result, this promotes the role of the platform economy in job creation and boosting consumption.

Haisheng Wu ***360 DigiTech, Inc. - CEO & Director***

(foreign language)

Mandy Dong ***IR Director***

[Interpreted] We have completed most of the rectification work according to the regulatory requirements and now in the stage of regular data reporting.

Regarding credit agency reform (Duanzhilian), we have already submitted our execution plans to regulators and have since maintained close dialogues with them. Based on feedback and direction from the regulators, we started to work with other business partners to implement our plans.

Haisheng Wu ***360 DigiTech, Inc. - CEO & Director***

(foreign language)

Mandy Dong ***IR Director***

[Interpreted] In July, the CBIRC published a notice on strengthening the management of Internet loan business of commercial banks and improving the quality and efficiency of financial services, namely circular #14. The document is consistent with earlier guidance, including circular #24 in 2021 and circular #9 in 2020, with the grace period extended for 1 year till June 30, 2023. In addition, the document once again acknowledges the collaborative business model between commercial banks and related parties in Internet lending business. We have already implemented the specific requirements outlined in this circular in our daily operations.

Haisheng Wu ***360 DigiTech, Inc. - CEO & Director***

(foreign language)

Mandy Dong ***IR Director***

[Interpreted] In Q2, despite multiple headwinds from the macro economy and unexpected pandemic resurgence, we remained committed to our strategy set at the beginning of the year. In this extreme volatile market, we successfully executed our operational strategy; and made great progress in funding, product, risk management and customer base as well as tech upgrading.

Haisheng Wu ***360 DigiTech, Inc. - CEO & Director***

(foreign language)

Mandy Dong ***IR Director***

[Interpreted] On the funding front, we further optimized our funding structure. During the quarter, we added 10 more joint stock banks and major urban and rural commercial banks with over RMB 1 trillion AUM, which make our funding supply more abundant. Thanks to improved funding supply and the resumption of insurance of ABS, our funding costs for credit-driven loans decreased by 21 basis points on a sequential basis. Since the beginning of Q2, we have issued a total of RMB 3.3 billion ABS at an average funding cost of 5%.

Haisheng Wu ***360 DigiTech, Inc. - CEO & Director***

(foreign language)

Mandy Dong ***IR Director***

[Interpreted] On the product front, we continued to optimize products portfolios and lowered our average price. This marks our full compliance of Cap 24% regulatory requirements.

Haisheng Wu ***360 DigiTech, Inc. - CEO & Director***

(foreign language)

Mandy Dong ***IR Director***

[Interpreted] On the customer acquisition front, we continued to upgrade our user base during the quarter. By expanding the coverage of our intelligent marketing RTA, namely real-time API model, we further increased the number of high-quality users and improved overall user quality. The coverage ratio of our precise targeting RTA model increased from, 5-0, 50% in Q1 to almost 100% in Q2. In the online advertising channels, the number of high-quality users with granted credit lines increased by 51% from Q1. Looking across all customer acquisition channels, the credit approval rate of high-quality user increased by roughly 20% on a sequential basis.

Meanwhile, we continue to enhance effectiveness of targeted customer acquisition. On one hand, we continuously upgrade our model for user quality screening. On the other hand, we expanded our media partner network for joint modeling and onboarded new partners such as ByteDance. For our existing partners such as Baidu, Tencent and Kuaishou, we continued to upgrade our models. In other areas, we optimized the cost efficiency of user acquisition by upgrading our intelligent marketing platform. We also connected to new user acquisition resource such as Baidu's open-screen ads and Toutiao's RTA resources.

Haisheng Wu ***360 DigiTech, Inc. - CEO & Director***

(foreign language)

Mandy Dong ***IR Director***

[Interpreted] In Q2, we quickly adjusted our risk strategies in response to resurgence of the pandemic, including acquiring higher-quality customers and gradually cutting off high-risk users. We also completed major upgrades of our risk models to further leverage on users' data. As a result, risk performance of new loan origination was great. First payment day-1 delinquency rate of new customers dropped to 3.01% in Q2 from 3.56% in Q1. And first payment delinquency 30 days was less than 0.25% in Q2. In the meantime, day-1 delinquency rate of our current loan book gradually went down to 4.71% in June from 5.11% in March. Such positive trends continued into July, with day-1 delinquency rate further dropped to 4.64%. The overall M1 collection rate of current loan book trended up to 86.9% in June compared to 85.2% in March.

Haisheng Wu ***360 DigiTech, Inc. - CEO & Director***

(foreign language)

Mandy Dong ***IR Director***

[Interpreted] Despite the impact of the pandemic, our overall asset quality improved in Q2, especially for new loan origination. This reflected the effectiveness of the adjustments we make and our ability to counter pandemic-related challenges. If macro circumstances stabilize for the rest of the year, we expect our risk management strategies to bring further improvement in asset quality.

Haisheng Wu ***360 DigiTech, Inc. - CEO & Director***

(foreign language)

Mandy Dong ***IR Director***

[Interpreted] In terms of tech upgrading strategy, we maintained that 55.7% of the loans originated and facilitated was under the capital-light model and other tech solutions in Q2. In the long run, we plan to modernize our leading technology into more products and better serve diverse financial institutions. In addition, the China Academy of Information and Communications Technology, namely CAICT, granted us among the first batch of companies under the business security initiative, namely BSI, together with industry giants, including China Mobile, Ant group, Baidu and et cetera. This was a strong statement of our capabilities in business security management and technology.

Haisheng Wu ***360 DigiTech, Inc. - CEO & Director***

(foreign language)

Mandy Dong ***IR Director***

[Interpreted] In Q2, we navigated through the extreme pandemic situation of citywide lockdowns and other multiple macro fluctuations with strong operational and financial results. Looking ahead into Q3, we will stay vigilant on the macroeconomic environment and the pandemic development. Meanwhile, we are seeing an increasingly stable policy environment and a healthier industry ecosystem. We will maintain a prudent operational strategy, continue to upgrade our technology and customer base and finish our rectification tasks.

Haisheng Wu ***360 DigiTech, Inc. - CEO & Director***

(foreign language)

Zuoli Xu ***360 DigiTech, Inc. - CFO & Director***

Okay, thank you, everyone. Thank you, Haisheng. Good morning and good evening, everyone. Welcome to our second quarter earnings call.

As Haisheng discussed, we delivered another solid quarter in a rather challenging period of time from a macro economic perspective. Early in the quarter, COVID lockdowns in Shanghai and other regions of the nation noticeably weakened consumers' confidence and altered consumption pattern for many. Since the lockdown removed in June, we have observed some recovery in consumers' demand for credit, although the pace of the recovery are expected to be gradual and modest.

Despite the impact from COVID and a generally soft macro environment, we continued to push for steady improvement in overall asset quality throughout the quarter and the year. With optimization of the risk model and contribution from high-quality new borrowers, overall day-1 delinquency has been declining sequentially each and every month since beginning of this year, even during the peak of the COVID lockdown in April and May. It was 4.9% for Q2 versus 5.2% in Q1 and further declined to 4.6% in July. Particularly, day-1 delinquency for new borrowers in Q2 was well below 4%, indicating clear better quality versus existing borrowers.

30-day collection rate remained stable at around 86% in Q2. COVID lockdowns significantly hampered our collection operation in April and early May. 30-day collection rate hit the lowest point of the cycle in April at less than 85% then start to recover. By July, it was already above 87%, the highest point so far this year. Again we see clear outperformance by new borrowers versus existing borrowers. For new borrowers, 30-day collection rate was above 90% in Q2. These risk metrics continue to support our current user acquisition strategy, which focuses on high-quality segment of the market.

Total net revenues for Q2 was CNY 4.2 billion versus CNY 4.3 billion in Q1 and CNY 4 billion a year ago. Revenue from credit-driven service, capital heavy, was CNY 2.9 billion compared to CNY 2.9 billion in Q1 and CNY 2.4 billion a year ago. The year-on-year growth was mainly due to growth in loan volume and longer average tenor of the loans, more than offsetting the negative impact from declining in average prices of the loans. Capital-heavy facilitation revenue, take rate actually improved modestly versus Q1 also due to longer loan tenor.

Revenue from platform service, capital light, was CNY 1.2 billion compared to CNY 1.4 billion in Q1 and CNY 1.6 billion a year ago. The year-on-year and sequential decline was mainly due to the decline in loan volume and the average price of the capital-light loan facilitation. During the quarter, capital-light loan facilitation, ICE and other technology solution combined accounted for roughly 56% of the total loan volume.

Given the challenging macro environment, we purposely increased the portion of the loans processed through ICE and other technology solutions to further mitigate potential risks so far this year. Such services typically have different commercial terms compared to regular capital-light loan facilitation. Overall, in the long run, we will continue to pursue technology-driven business model and expect capital light and other technology solutions to eventually become a significant majority of our business.

During the quarter, average IRR prices of the loans we originated and/or facilitated further dropped to between 22% and 23%, well within the 24% rate cap requirement. We expect pricing to be relatively stable for the coming quarters.

Sales and marketing expenses increased approximately 11% sequentially in Q2 mainly because of the increase in high-quality user acquisition. Specifically, if we exclude back-end expenses, the increase in average costs to acquire a 360 Jietiao new credit line user through third-party traffic sources were roughly in line with increase in the average size of the new credit lines. As such, the average cost per dollar amount of new credit line remained relatively stable Q-on-Q. As always, we will continue to use life cycle ROI and LTV as key metrics to determine the pace and scope of our user acquisition strategy to ensure the sustainability and profitability of our operations.

Although the overall risk profile of our loan portfolio continued to improve in Q2 due to contribution from new loans from high-quality new users, impacts from macro uncertainty and COVID were still apparent on old loans from existing users. Therefore, we continued to take prudent approach in booking provisions against potential credit loss. New provisions for contingent liability for loans facilitated in the quarter was approximately CNY 1.3 billion.

With strong operating results and stable contribution from capital-light model, our leverage ratio, which is defined as risk-bearing loan balance divided by shareholders' equity, was at historical low of 4.0x in Q2 compared to 4.8x a year ago. We expect to see rather stable leverage ratio for the time being until capital light and other technology solution contribution become a bigger portion of the business in the future.

We generated CNY 1.1 billion in cash from operation in Q2 compared to CNY 1.4 billion in Q1. The sequential decline in operating cash flow was in part due to some COVID-related timing issue. As Shanghai being gradually reopened in late Q2, some of the business and administrative procedures within the financial system were still not running as efficiently as what normally should be, therefore causing some delays in collecting receivables from some of our financial institution partners. Total cash and cash equivalents was CNY 11.4 billion in Q2 compared to CNY 9.8 billion in Q1. Nonrestricted cash was approximately CNY 7 billion in Q2 versus CNY 6.2 billion in Q1.

As always, a significant portion of our cash will normally be allocated to support the security deposit with our institution partners in normal business course. As we continue to generate healthy cash flow from operations, we believe our current cash position is sufficient to support the growth of our business, to invest in key technologies and to satisfy potential regulatory requirement and to return to our shareholders.

In accordance with the dividend policy approved by our Board last year, we declared another quarterly dividend of USD 0.18 per ADS for Q2. The cash dividends represent approximately 20% of our Q2 earnings.

Finally, regarding our outlook for 2022. As we discussed previously, we believe 2022 will be a fairly challenging year for the industry as the participants are settling in a new regulatory environment. Meanwhile, the on-and-off outbreak of COVID as well as associated measures to control the outbreak added additional uncertainties to an already soft macro economy. Therefore, we want to maintain a prudent approach to plan our business and mitigate potential risk. At this point in time, we would like to keep our full year loan volume guidance of between RMB 410 billion and RMB 450 billion unchanged, representing year-on-year growth of 15% to 26%.

We view this transitional year as an opportunity for us to further optimize our operation, strengthen our technology platform and upgrade our customer base to build an even stronger foundation for our future growth. As always, the forecast reflects the company's current and preliminary view, which is subject to material changes.

With that, I would like to conclude our prepared remarks. Operator, we can now take some questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question is from Yada Li, CICC.

Yada Li ***China International Capital Corporation Limited, Research Division - Analyst***

(foreign language) Okay. Then I'll do the translation part. So under the current macroeconomic and pandemic uncertainties -- so with most of the retail credit service providers or the financial institutions generally have encountered certain pressure, such as the increase of customers' early prepayments, the customer acquisition challenges after the pricing adjustments. So I was wondering in the context of these uncertainties, are there any changes in the willingness of our bank partners to cooperate with us? And are there any changes in the funding costs, the customer acquisition costs, and also the actual borrowing demand of our potential customers? And if there were some certain challenges with our plans, then how are we going to overcome it?

Haisheng Wu ***360 DigiTech, Inc. - CEO & Director***

(foreign language)

Mandy Dong ***IR Director***

[Interpreted] Yes, I will answer your question, Yada. First, your observation is correct. Due to the impact of macro economy, financial institutions are under some pressures. However, thanks to our, number one, accumulated credibility in the market, from our consumer loan business -- number two, financial institutions' pressure from other asset class. Actually, in Q2, our high-quality consumer loan assets were in high demand from financial institutions. That is reflected by the drop in funding costs that we already discussed. In July and August, we are seeing the trending down of funding costs further. For your second question, as for the customer acquisition activities, due to the lockdown of pandemic, our off-line activities, our customer drawdown activities were to some extent negatively impacted. Thanks to a series of countermeasures, we applied more precise customer targeting. That's on the drawdown activity of our users boosting. We have done a lot of work in Q2. We are expecting to see the work bearing fruit in Q3.

Haisheng Wu ***360 DigiTech, Inc. - CEO & Director***

(foreign language)

Yada Li ***China International Capital Corporation Limited, Research Division - Analyst***

(foreign language)

Operator

Our next questions is from Thomas Chong from Jefferies.

Thomas Chong ***Jefferies LLC, Research Division - Equity Analyst***

(foreign language) My first question is about our SME strategies. Given the current macro backdrops, we scaled back the pace of our SME business as well as the off-line sales team. And my second question is about the average ticket size. Given the uncertainties of the macro environments, are we seeing the borrowers are getting a lower ticket size and they are getting a bit more prudent in borrowing?

Haisheng Wu ***360 DigiTech, Inc. - CEO & Director***

(foreign language)

Mandy Dong ***IR Director***

[Interpreted] Yes, regarding SME business. Naturally this is more cyclical than our consumer loan business. That's we take a more prudent approach on this business line. We have tightened our credit standards for this business. As you can see, the total loan origination or facilitations in SME business in Q2 dropped a bit. This is number one. For the second point, as for the customer acquisition channel, for external channels that we have less control, we scaled back the volume, and more focused on our direct sales team of off-line customer acquisition.

Haisheng Wu ***360 DigiTech, Inc. - CEO & Director***

(foreign language)

Mandy Dong ***IR Director***

[Interpreted] Yes, Thomas, your observation that the customer consumption willingness dropped due to the impact of pandemic is correct. However, we released a few countermeasures. Number one is we tightened the credit standards. That means the approval rate is lower. Number two, we focus more on the high-quality customers which bring more value to the business. The 2 measures together makes our ticket size relatively stable.

Zuoli Xu ***360 DigiTech, Inc. - CFO & Director***

Okay, Thomas, just to add a couple more points there. One is on the SME. As Haisheng mentioned, if you look at our earnings release, this quarter, the new credit line granted to SMEs was CNY 4.9 billion. And the actual loan facilitated or originated to SME was about CNY 7.8 billion roughly. Compared to last quarter, that loan volume was a little bit over CNY 10 billion. So that's the numbers there. But I just want to make sure when we talk about SME, we are talking about rather narrowly defined SME, so meaning like that's real SME, as opposed to some of the players talking about more broadly defined SME. So that makes a difference. Secondly, regarding the ticket size. If we look at, for example, average drawdown, we look at for Q2, it increased by roughly 5% sequentially. So that's just added points to Haisheng's comments. When we passed through the lockdown period, we actually still see pretty noticeable growth in terms of ticket size in consumption. Thank you.

Operator

(Operator Instructions) Our next question is from Alex Ye from UBS.

Xiaoxiong Ye ***UBS Investment Bank, Research Division - China Financials Research Associate***

(foreign language) So my question is mainly on your take rate outlook. So you have mentioned that your average IRR during the quarter was 22% to 23% and expect that to remain stable going forward. And you also mentioned that your funding cost is improving and your credit performance is also stabilizing, so I'm wondering if we could expect some of stability or improvement to your take rate going forward.

Zuoli Xu ***360 DigiTech, Inc. - CFO & Director***

Sure, Alex. Let me take your question here. Generally you're right. Given that we already reached the point in terms of pricing goal based on the regulatory guidelines, so we don't see really too much pricing downward trend going forward for the remainder of the year. And with that -- and the overall take rate, I would say you probably will see a more stable take rate. If anything, there could be some improvement there, but of course, other factors you need to consider is number one, the macro environment. And that will have a -- I will say, more impact than usual. If we have a rather stable macro environment, then we can assume it will be a stable to maybe modestly improved take rate, but if it's something unexpected happening on the macro front, then there will be another question there.

From funding costs. As Haisheng mentioned, sure, second quarter, we're 6.8%. And right now we are sitting at about 6.5%, so there's maybe still a little bit room to go in terms of lowering funding costs given the current money supply is pretty available out there. There may be still some room to go, but overall I will say from a modeling perspective conservatively you can model a rather stable take rate. If you want to add some to it modestly, then that's also fine.

Operator

Our next question is from Richard from Morgan Stanley.

Ran Xu ***Morgan Stanley, Research Division - MD***

(foreign language) Basically my question is on the competitive environment in China at the moment. Given 360 DigiTech is also aiming for low-risk borrowers, basically it's also some overlap with the targeted customer by like Ant, banks, et cetera. So what's the competitive landscape at the moment?

Haisheng Wu ***360 DigiTech, Inc. - CEO & Director***

(foreign language)

Mandy Dong ***IR Director***

[Interpreted] Yes, Richard, you are right. After we lowered our average product price, the overlap of target markets with other players, like you mentioned, Ant or banks, that increased a little bit. However, we do not see the direct head-to-head competition with them. There are a few reasons. Number one, the consumer loan market is a grand market with multi layers. For example, banks, they have 10% price, product. Ant has 15%. Our price range, as we discussed previously, is between 22% and 23%. Number two, we believe different companies can thrive and prospers based on their unique competence. For example, Ant has Zhifubao, their unique ecosystem. For us, we do not have any e-commerce platform or e-commerce ecosystem. Therefore, we can collaborate with all the platforms in the market and cover the full spectrum of customer groups.

Haisheng Wu ***360 DigiTech, Inc. - CEO & Director***

(foreign language)

Ran Xu ***Morgan Stanley, Research Division - MD***

(foreign language)

Operator

And our next question is from Hans Fan, CLSA.

Hans Haishuo Fan ***CLSA Limited, Research Division - Research Analyst***

(foreign language) So let me translate. So my question is more about asset quality. Management just mentioned that looking to the second half, we're going to see improvements in overall risk indicator. My question is more about how do we see the path of these improvements. Is it like a gradual, bumpy one; or like a notable uptrend, especially regarding the COVID flare-ups recently across many cities. And also, when do we expect the 90-day delinquency ratio to peak? Yes, that's my question.

Haisheng Wu ***360 DigiTech, Inc. - CEO & Director***

(foreign language)

Yan Zheng ***360 DigiTech, Inc. - Chief Risk Officer***

(foreign language)

Yao Lu

[Interpreted] Okay. So our risk management team has been working with other teams closely to make several adjustments in the second quarter: firstly, improving the quality of newly acquired customers. With the comprehensive coverage of RTA and the integration of the Pre-A model, the number of our best-quality customers has been doubled compared with the first quarter. And secondly, improving the data mining of the People's Bank of China credit report, we have set up a joint project team and derived 18,000 effective variables the credit report, covering the optimization of several models, including competitive offer exploration, high-quality customers identification, bad customers identification, career model, income and liability model, et cetera. And in the meanwhile, we evaluate customers with poor credit performance more cautiously. Thirdly, we improved the resource allocation to high-quality customers on the operations side, including pricing, credit lines and promotion.

With these actions, the credit performance of new transactions has been improved. We have seen that FPD 30 days in Q2 dropped by about 20% compared with first quarter and maintained a downward trend in July and August. With the epidemic outbreak, we could still lower our risks, which fully demonstrates the resilience of our team and our assets. Moreover, the results of some actions mentioned above have not been fully reflected as some actions are in pilot testing. We need to observe long-term performance. Therefore, with full adoptions of these actions, we are very confident to retain stable risk performance in the future. As for 90-day delinquency rates, it will be lower in third quarter as we focus more on 30-day delinquency rate. It has been the lowest in July. And our future target will be within 2.5% to 3%. Hope this can clarify your questions.

Operator

And this is the end of our question-and-answer session. And now I hand back to your management for conclusion.

Zuoli Xu ***360 DigiTech, Inc. - CFO & Director***

Okay, thanks again for joining us, the conference call. If you have any additional questions, please feel free. Contact us offline. Thank you.

[Portions of this transcript that are marked [Interpreted] were spoken by an interpreter present on the live call.]