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Q2 2019 360 Finance Inc Earnings Call

EVENT DATE/TIME: AUGUST 23, 2019 / 12:00PM GMT

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PRESENTATION

Operator

Hello, and welcome to the conference call entitled 360 Finance Announces Second Quarter 2019 Unaudited Financial Results. (Operator Instructions) Please note, this event is being recorded. I would now like to turn the conference over to Matthew Li of 360 Finance. Please go ahead.

Matthew Li ***360 Finance, Inc. - IR Officer***

Thank you, operator. Hello, everyone, and welcome to our second quarter 2019 earnings conference call. Our results were issued earlier today and can be found on our IR website.

Joining me today on the call are Mr. Haisheng Wu, our CEO and Director; Mr. Alex Wu, our CFO; and Mr. Yan Zheng, our Vice President.

Before we begin our prepared remarks, I would like to remind you of the company's safe harbor statement in connection with today's conference call. Except for any historical information, the material discussed on this conference call may contain forward-looking statements. These statements are based on our current plans, estimates and projections and, therefore, you should not place undue reliance on them. Forward-looking statements involve inherent risks and uncertainties. We caution that a number of important factors could cause actual results to differ materially from those contained in any forward-looking statement. For more information about potential risks and uncertainties, please refer to the company's filings with the SEC in its registration statements. In addition, this call will also include discussions of certain non-GAAP financial measures. Please refer to our earnings release, which contains a reconciliation of the non-GAAP measures to the most directly comparable GAAP measures.

Finally, please note that unless otherwise stated, all figures mentioned during this conference call are in renminbi.

With that, I will turn the call over to our CEO, Mr. Wu. Please begin.

Haisheng Wu ***360 Finance, Inc. - President, CEO & Director***

Okay. Thanks, Matt, and thank you, everyone, for joining our call today. This is Wu Haisheng, and we're sorry that Mr. Xu Jun is not able to join us today since he has to leave the company for personal and family reasons. We would like to thank him for his extraordinary services to 360 Finance as our Cofounder and the CEO.

Our business fundamentals are very strong. We will continue to execute our strategy to building our company into a financial technology company. Our core team members have been working together very well, and we expect the transition process will be very smooth.

We believe our advantage, our structure and systematic, we have established a solid foundation for our business in China. We believe our structural advantage will not be impacted by the change of one management member.

Now I will go back to my prepared remarks. We are pleased to further solidify our leading position in the industry with another solid quarter. As of June 30, 2019, we have cumulatively originated RMB 270 billion of loans through our platform with outstanding loan balance of RMB 51.3 billion. Our cumulatively registered users reached 109 million. Users with credit line reached 19.2 million, and the cumulative borrower with successful drawdown reached 12.5 million. We are very proud of reaching such a huge user base and business figure in just 3 short years since we founded the company.

In the second quarter, we acquired 14.2 million registered users, granted credit line to 3.2 million borrowers, and we had 2.1 million borrower with successful drawdown. Our loan origination volume increased by 127% year-over-year and 17% from the previous quarters to RMB 48.4 billion. While we continue to grow our business quickly and consistently, we have been able to efficiently manage our borrowers' credit risk. Our market-leading risk management capabilities is well recognized by our institutional funding partners. It has enabled us to obtain sufficient institutional funding at competitive rates and offer more affordable credit products to our users.

As of June 30, we have established partnerships with 62 financial institutions. We believe this achievement strongly demonstrates our leading position in terms of scale, growth and risk management. Our strong business development is primarily driven by our expanding user base and continuous investments in advanced technologies, such as big data and artificial intelligence.

We have also vigorously invested in brand promotions and user acquisition to quickly build up a huge user base. In less than 3 years, we have been able to acquire more than 100 million registered users. We firmly believe that our spend on user acquisition is a long-term investment for revenue and profit generation in the future. We have clearly demonstrated that we can continue to benefit from our proactive user acquisition strategy in the long run based on earnings from borrowers' first drawdown and enough to cover the related acquisition cost.

Leveraging our user acquisition system that is driven by big data, we are working with nearly 100 third-party channels to acquire higher-quality users. Through the application of machine learning techniques, we are able to assess a borrower's credit profile and their ability to borrow, which helps us achieve more prefab user packaging and improves our overall user acquisition capabilities.

In the second quarter, we stopped investing in some channels that's the source to lower-quality borrowers and improved our overall user quality and acquisition efficiency. We also launched several new acquisition initiatives in the quarter. For example, we made a strategic investment in a social e-commerce platform with strong growth momentum. We also established an offline sales force to promote our products and services to customers. We will further diversify our user acquisition channels in the future.

As I mentioned earlier, we have established a huge user base of 109 million registered users. We have already served 12.5 million of them with our existing products and services. This tells us that we still have huge opportunities to tap into our existing user base and increase conversions. We will further address the various needs of our huge user base by providing them with more diversified products and services. In addition to our strong presence in the domestic market, we are actively exploring opportunities to extend our fintech services to select international markets in Southeast Asia and South Asia.

Our firm commitment to investing in big data and artificial intelligence have enabled us to aggregate a massive amount of data and use extremely strong data processing capabilities. For example, our social network system covers 2 billion relational views and 19.2 billion relational that we are able to refresh our system every 3 seconds and analyze 1.5 terabytes of data on value basis.

Meanwhile, we have made significant processes on data mining and risk modeling. For each applicant, we collect more than 4,000 basic variables. From this, more than 100,000 -- 200,000 variables are derived and 200 sub costs are calculated by our training machine learning model. With these variables and sub costs, our entire dependency is now composed of over 10,000 branches. It is built to perform a dedicated risk evaluation, and each applicant can accordingly be allocated with the most appropriate credit and pricing. By applying cutting-edge AI technology, we have really set ourselves apart from -- apart with our industry-leading risk management, and these have helped us ensure higher asset quality.

In addition, we have deployed AI robots in various operational functions to improve the standardization of our operations and reduce operational risk and labor cost. As of June this year, 75% of our collection work, 77% of our telemarketing work and 99% of customer service work have been performed by our AI robots. The remaining work of collection, marketing and customer service is performed by humans, though we actually use AI robots there as well for quality inspection.

So you can see we have made great efforts in technology. And the result this year, as of June 30, we have submitted applications for 139 patents for our financial technologies. We also joined hands with Shanghai Jiao Tong University to establish a lab to study the most cutting-edge AI algorithm for applications in our risk management and marketing management strategies, which will further strengthen our team's technique, capabilities.

Based on our strong technology capabilities, we will focus more on providing technology services to our partners. We have significantly increased our loan origination and our capitalized model for our institutional funding partners. We expect this trend to continue in the coming quarters.

With that, I will turn the call over to our CFO, Alex, to discuss our financial results.

Jiang Wu *360 Finance, Inc. - CFO*

Thank you, Haisheng. Since our operational and financial results were released earlier today, I will only comment on a few highlights.

Our Q2 financial results continue to be very solid as our total net revenues increased by 128% year-over-year and 11% from the previous quarter to CNY 2.2 billion. This brings our total net revenues in the first 6 months of this year to CNY 4.2 billion, which means that we have already accomplished about 50% of our full year revenue guidance of CNY 8 billion to CNY 8.5 billion. The momentum is very strong in the foreseeable future, and we remain very confident in achieving our full year results provided in our guidance.

In addition to drive -- driving the static growth of our business, we also optimized the mix of loan facilities under different models. During the second quarter, we originated CNY 3.8 billion of loan under a capital-light model, which brings 0 credit risk to our company. Loans originated under the capital-light model accounts for approximately 8% of the total loan origination during the second quarter, which is significantly higher than less than 1% in the previous quarter. We expect this trend will continue as we focus on providing technology services to our institutional funding partners.

In the second quarter, we also originated CNY 3.5 billion on-balance sheet loans through consolidated trust, which increased by 70% from previous quarter and accounted for 7.5% of loan origination volume in Q2. The on-balance sheet loans generate financing income and better match revenue recognition with the cash flow. As we are seeing a declining trend of funding cost from trusts, we plan to originate more on-balance sheet loan through consolidated trusts in the coming few quarters.

While most of the cost items are largely in line with the growth of our business, I would like to reiterate our view on sales and marketing expenses. In order to sustain our growth in the long run, we continue to invest vigorously in brand promotion and customer acquisition. As Haisheng just mentioned, we strongly believe that user acquisition is a long-term investment instead of a short-term expense. In the second quarter, our sales and marketing expense were CNY 839 million despite the increase in our user acquisition cost due to competitive market conditions. The return on investment of our borrowers remains attractive. Based on our calculations, the earnings from the borrowers' first drawdown are enough to cover all the costs. And on a daily basis, we closely monitor this parameter to drive our customer acquisition business.

Turning to the balance sheet. At the end of Q2, we had a total cash of CNY 4.2 billion, including cash and cash equivalents, restricted cash and security deposit prepaid to third-party guarantee companies. Our total cash increased by 49% from the end of June 2018 and 25% from the first quarter. Our strong operating performance is well recognized by renowned financial institutions, and we were able to obtain short-term loans of CNY 1.4 billion in the second quarter to further enhance our working capital. We believe we have a very strong cash position to support our business growth and daily operations.

Finally, I would like to mention a little bit about our upsized public filing -- public offering of more than 11 million ADS in late Jun. All the ADS sold were secondary shares from several of our early-stage financial investors. We would like to thank the selling shareholders for their support in the past, and we sincerely welcome the new investors. The fundamentals of our company are very strong, and we are confident that we are able to create sustainable value for all shareholders in the future.

With that, I will conclude our prepared remarks and open the floor for questions. Thank you.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) The first question comes from John Cai of Morgan Stanley.

John Cai ***Morgan Stanley, Research Division - Research Associate***

Congratulations on the continuing strong growth momentum for this quarter. So my first question is about the capital-light model. Can the management share more details on the economics of this capital-light model as compared to our traditional funding models? And also what proportion or percentage do we see these capital-light funding trend in the future? If it's, for example, towards the end of the year, what percentage of the loan facilitation would come from this capital-light model?

And my second question is about the cash. I think I'm looking at the free cash of CNY 1.8 billion there, so it's increased on a year-on-year -- sorry, on a Q-on-Q basis. I think as our loan book continue to grow obviously our free -- our cash flow on a monthly basis will continue to increase. So just wonder what we see this free cash trending, in particular, given we have some plan to invest in the international market.

And the final question is about costs. So I think -- actually, I have 2 questions, 2 more questions. The first one is about the origination cost. It seems it's increased on a Q-on-Q basis. Just wondering if there's more color on that. And the final one is about the delinquency rate. It edged up a little bit to 1% for the 90 days delinquency, so if there's any colors on that, it would be great as well.

Jiang Wu ***360 Finance, Inc. - CFO***

Okay. Thank you, John. Let me answer your first 3 questions. I will turn that question -- turn the last question to our CIO talking about the delinquency rate, okay?

So for the capital-light model, it's essentially just we don't take any credit risks. We just transfer all the economics to the financial institutions, our partners. The economics will be a little bit lower compared with the traditional model, facilitation model obviously but it's manageable for us. And we think that it will help us to build up a healthy -- more healthy loan book in the long run.

And in terms of percentage, as I just mentioned, we had -- we see 8% loan origination in the last quarter, and the percentage will continue to go up. It really depends on the interaction between the customers, financial institutional partners and our risk model. We can't give you a specific number, but we are very confident to see that percentage go up to double digit, more double digit in -- by the end of this year. So that's the first question.

The second one for the cash, I think that you are correct that this cash position highly correlate with our business model. So given that we see our business very solid in the coming few quarters, the cash position will continue going up.

We -- and for the third question, the origination, I think there are -- the key reason is we increased on-balance sheet loan. The financing cost for the on-balance sheet loan will be record in that -- under that item, so it increased a little bit for. So that's -- that means that if we continue to increase on-balance sheet loans, the so-called origination and servicing fee will continue to go up, but that's primarily driven by the on-balance sheet loans' financing cost. That's the third question.

So for the last question, let me just turn to our CIO.

Yan Zheng ***360 Finance, Inc. - VP***

(foreign language)

Matthew Li ***360 Finance, Inc. - IR Officer***

This is Matthew. I will translate it for Mr. Zheng.

[Interpreted] So although we see a slight increase of our M3+ delinquencies we showed in the second quarter to 1.02%, so we believe this is still an industry-leading level if you compare it with other players. So we think when we look at our risk performance of our loans, by vintage, the numbers makes more sense. So if you look at the vintage performance of our M6+ delinquency rate, we also included that in our earnings release. So the loans we facilitated in the recent quarters are actually performing better than the ones we facilitated in Q2 of last year, so we're seeing an improving trend of our risk management.

Jiang Wu ***360 Finance, Inc. - CFO***

John, I hope all of this answer your questions.

John Cai ***Morgan Stanley, Research Division - Research Associate***

Yes. It's very helpful. Congratulations.

Operator

The next question comes from Steven Chan of Haitong International.

Sik Tin Chan ***Haitong International Research Limited - Executive Director***

This is Steven Chan of Haitong. Three questions for me. First of all, if my calculation is correct, I think that your take rate for the traditional loan facilitation business has been declining in Q2 compared to Q1. And I would like to know what's the rationale behind. Is that because higher guarantee cost, lower lending rate or higher funding cost? So that's my first question.

Second question, going back to the capital-light model, you mentioned that you're targeting double digit towards the end of the year. Do you have any sort of like medium-term target for this capital-light model?

And I would also like to know whether -- because I suppose this would be some gray area from the regulator's point because the regulators may not even encourage microfinance company to issue ABS or whatever. So I'm not sure how large these proportion could grow. So could you give us sort of like a medium-term target, say, 3 to 5 years' time, what's the proportion you're expecting that to reach?

And finally, about acquisition costs. My rough calculation is that it has increased further from Q1 around CNY 200 million now to around CNY 260 million, if my calculation is correct. So I just want to know how much more you can afford to rise on this acquisition -- customer acquisition cost? So basically, these 3 questions.

Jiang Wu ***360 Finance, Inc. - CFO***

Thank you, Steven. Very good questions. Let me just answer first and see our CIO will have any further points to add. Right, just for the take rate, you are correct, if you just use a lump sum number to calculate the take rate, the gross take rate will decrease a little bit in the second quarter. The key reason is not because of the guarantee liability or the cost. That's because, what I just mentioned, we originate -- we have used this capital-light model to -- that will decrease the economic a little bit, but we are more -- the whole book is more healthy. So if you take that capital-light model out, the traditional model take rate are relatively stable, okay, and actually, it's slightly going up a little bit.

To answer your second question, first of all, capital-light model is not ABS, okay? It's just a -- it's a pure -- for us, it's pure technology services. We basically help the financial institution to find customers, do the preliminary risk analysis and help them do the post-origination collections and other services. The only difference between capital-light model and the traditional model is we don't take any credit risk. The financial institution will take all the credit risk, okay? So it's not ABS issue. So we don't see any regulation hurdle for that portion. So in going forward, in the long run, we don't have a number yet, but we are very confident to increase that portion significantly as long as the financial institution are willing to take that.

For the third question, acquisition cost, yes, it continues to grow up -- growing up, as I just -- in my remark, I just mentioned that primarily due to the competition landscape, but we still see that as a long-term investment. And as long as the return on investment for the customers are sound and attractive, we will continue to do that.

And as I just mentioned, for the first loan drawdown, we can easily breakeven for all the costs. So we don't see any reason to stop there. This is a long-term investment. And maybe Haisheng will have something to add on the previous questions.

Haisheng Wu ***360 Finance, Inc. - President, CEO & Director***

Okay. I need to speak in Chinese. I'm sorry. (foreign language) Matt?

Matthew Li ***360 Finance, Inc. - IR Officer***

This is Matthew translating.

Sik Tin Chan ***Haitong International Research Limited - Executive Director***

Can I have 2 follow-up on that? Yes. First of all -- yes, yes, sorry for that.

Matthew Li ***360 Finance, Inc. - IR Officer***

Yes. So let me finish with the translation first.

[Interpreted] So as Alex mentioned, so on our current customer acquisition, we are still able to cover the borrowers' acquisition cost as they initial drawdown the loans. And our repeat borrower contribution keeps increasing in this quarter. So we believe the ROI, the return of investments of our sales and marketing expenses is still very attractive, and we think give us a long-term investment. And currently, we have very sufficient funding for many of our institutional funding partners. And we continue to see very strong demand from our users, from our borrowers. And at the same time, we have been performing very solid risk management of our assets. So that's why we believe the spending on sales and marketing is a long-term investment instead of a short-term expense.

In term of numbers, our CEO, Haisheng, mentioned our large user base earlier. Even we stop spending for new customer acquisitions and focus on our existing users, our loan transaction volume will still be very large. So in Q2, our total loan facilitation volume was CNY 48.4 billion, and our repeatable contribution was about 70%, which translates to CNY 33.8 billion of loans. So as you can see, as our repeat borrower contribution continue to increase, we'll still be able to achieve a very large transaction volume. So that's why we're focusing more on the future benefits instead of the short-term income or revenues.

Sik Tin Chan ***Haitong International Research Limited - Executive Director***

Can I have 2 more follow-up questions on the previous question?

Matthew Li ***360 Finance, Inc. - IR Officer***

Yes. Sure, sure. Please go ahead.

Sik Tin Chan ***Haitong International Research Limited - Executive Director***

First of all, I think I mixed up the capital-light with the on-balance sheet. So indeed, my question should be for the ABS or trust scheme to be more related to the on-balance sheet because we're seeing a very substantial rise in the on-balance sheet loans. So how much larger are we foreseeing for that part to grow in the coming years?

And second follow-up question is, I think a lot the -- I met a lot of investors, they have big concern about the capital-light return. So could you give us some guidance about the, say, for example, maybe if we use the take rate, the take rate of the capital-light model compared with the traditional model, how much lower -- just a rough idea how much lower would that be?

Jiang Wu ***360 Finance, Inc. - CFO***

Yes. Sure. So for the on-balance sheet assets, it's basically -- it's primarily accounting treatment, okay? Structural-wise, it's the same as our refinance. So there's no -- if there's some hurdle from regulation on this business, there will be a hurdle on the on-balance sheet loan as well. It doesn't really matter, okay?

For the second question, the take rate, given that we didn't publish all these data also I can't give you the exact numbers. But it really depends on the assets we offload. For example, if we offload the asset with APR 36%, that means the take rate would -- the difference of the take rate would be very large. Compared with, if we offload the assets with APR, say, a little bit lower to say, for example, 24%, then the take rate difference would be quite small. Hope I answered partial of your questions, Steven.

Sik Tin Chan ***Haitong International Research Limited - Executive Director***

So you mean that's the take rate for the capital-light model?

Jiang Wu ***360 Finance, Inc. - CFO***

Yes. It's basically just -- so the model is you use the APR, just take a percentage of the APR as our technology service fee, that's it. And we don't deduct any credit cost. We don't deduct any financing cost. Okay.

Operator

(Operator Instructions) The next question comes from Alex Ye of UBS.

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

So I also have a follow-up on your capital-light model. So I wonder in terms of the funding partners that has utilized this model with you, I wonder what type of that partner are? So are they like the regional banks or national banks? And what is the -- your cooperation with them like? So does it take a long time of relationship between you and the funding partners before they are more comfortable to do this capital-light model with you? So -- and also are there any particular type of APR range that they're more comfortable to take on into -- when they do this model? So that's my first question.

And my second question is just to -- can I get an update on your average APR on the -- on your total loan presentation in the past quarter? Has it changed much from the around 50% from the last quarter?

Jiang Wu ***360 Finance, Inc. - CFO***

Thank you, Alex. Very good question. For the capital-light, the partners are, to be honest, all long-term partners. They know our asset. They know our operation. They know our risk analysis capability. So that includes all these regional banks, consumer finance companies and even national banks.

In terms of what kind of assets we offload to them, it really depends on the commercial discussion, the negotiation. So as of today, we primarily offload the high-APR asset to the financial institution partners. And to be honest, this model is not new. We did that last year. We did that in the first quarter as well but we just want to highlight that for the second quarter as well.

And for your second question, APR, actually -- the average APR dropped down a little bit. In the first quarter, the average APR for the whole loan book is 29 -- 29.3%. Now it's 29%. And we see that APR continue to go down a little bit.

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

Can I just have a follow-up -- quickly follow up?

Jiang Wu ***360 Finance, Inc. - CFO***

Sure. Sure.

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

So I would like to ask, so of your over 60 funding partners, how many of them are doing this capital-light model with us currently?

Jiang Wu ***360 Finance, Inc. - CFO***

Currently, only a few, single digits right now. But we're talking to a lot of partners in the past few months.

Operator

The next question comes from Daphne Poon of Citibank.

Daphne Poon ***Citigroup Inc, Research Division - Associate***

So just one quick follow-up on the cost management side. So you mentioned about the sales and marketing costs. You will continue to invest in that. So as you acquire, like, seeing that as a long-term investment. But in terms of the, maybe, more near-term margin outlook, so do you expect the operating margin to continue to decline because of the higher sales and marketing cost? And also any guidance or outlook for the customer acquisition cost level maybe for the next 2 quarters?

Jiang Wu ***360 Finance, Inc. - CFO***

Thank you, Daphne. We -- you raised a very good question. Yes. The margin will continue -- from that perspective, the margin will drop down a little bit in the coming few quarters that -- given that the acquisition cost will continue to go up as we see the competition is going up a little bit. But we have more channels in own discussion to mitigate that cost. So I think that's -- it's a very dynamic mechanism. It's a little bit difficult for us to foresee what exactly the number will be for the third quarter and the fourth quarter. And to be honest, in the third quarter, what we can see now, the acquisition cost actually draw down a little bit. So let's wait and see. But we will monitor that parameter on a daily basis. And our CEO, Haisheng, may add a few points on that.

Haisheng Wu ***360 Finance, Inc. - President, CEO & Director***

No. (foreign language)

Jiang Wu ***360 Finance, Inc. - CFO***

Okay. I think that's pretty much it for your question. I hope that answers your questions, Daphne.

Daphne Poon ***Citigroup Inc, Research Division - Associate***

Yes. So would you have any, like, target on the operating margin? Or as you mentioned, it's quite dynamic?

Jiang Wu ***360 Finance, Inc. - CFO***

From the operational -- operating margin, we see they'll be quite stable between around 40%. That's a non-GAAP basis, and then margin will be around 30% to 35%.

Operator

(Operator Instructions) This concludes our question-and-answer session. I would like to turn the conference back over to Matthew Li for any closing remarks.

Matthew Li ***360 Finance, Inc. - IR Officer***

Thank you, operator, and thank you, everyone, for joining us today on the call. So should you have any further questions going forward, please do not hesitate to contact us. Have a good day.

Operator

The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.