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Q1 2019 360 Finance Inc Earnings Call

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PRESENTATION

Operator

Good day and welcome to the 360 Finance First Quarter 2019 Earnings Conference Call. (Operator Instructions) Please note, this event is being recorded.

I would like to now turn the conference over to George Shao, Head of Investor Relations. Please go ahead.

George Shao ***360 Finance, Inc. - Head of IR***

Hello, everyone, and welcome to our first quarter of 2019 earnings conference call. Our results were issued earlier today and can be found on our IR section of our website.

Joining me today on the call are Mr. Jun Xu, our CEO; Mr. Haisheng Wu, our President; Mr. Alex Wu, our CFO; Mr. Yan Zheng, our Vice President; and Fan Zhang, our General Counsel.

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 SEC, including 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 RMB.

So with that, I will now turn the call over to our CEO, Mr. Xu.

Jun Xu ***360 Finance, Inc. - CEO & Director***

All right. Thank you, George, and thank you all for joining us today. We are pleased to report another strong quarter and I will cover 4 aspects of the business. First, we keep setting new records in terms of growth. We originated CNY 41 billion of loan and the outstanding balance reached CNY 53 billion, widening our leadership in the sector. We continued to invest heavily in the future. We added 3.5 million new users with credit line and 2.2 million followers, both a new record for the company. We will continue the growth strategy for the next couple of years. We have less than 1% of the consumer lending market in China and the headroom for growth is immense. The return on investment for new customer acquisition remains very attractive. We don't want to be a niche player. Our aspiration is to be a leading platform and serve most of the Chinese households with borrowing needs over time. We believe, in our sector growth is a privilege for leading platform rather than a choice. It requires a platform to possess the ability to source new customers at scale, to secure sufficient funding and to manage credit risk well simultaneously. Therefore, we have been seeing the market become increasingly concentrated in the last 18 months and we anticipate the leading platform will continue to grow faster than the industry average.

Secondly, I will talk about our credit quality. In spite of the faster growth, we continued to lead the industry in credit quality. 90 day+ delinquent ratio was 0.94% as of March 31, 2019. The annualized vintage loss rate, which is the ultimate metric we look at, continued to be within our expected rates and the [lead] industry, in line with our aspiration to serve most of Chinese households with borrowing needs over time and leveraging our improved credit risk management skills, we proactively extended services to users with different risk-adjusted returns. Although these near-prime segments carry higher charge-off rates, they generate higher risk-adjusted returns netting the effect of higher APRs and risks costs. In addition to serving more near-prime segment customers, we are also working on improving activities and thickness of the super-prime segments, we created a dedicated team for it to make sure we provide more credit lines and pricing for our best customers. We hope this will become another important source of growth for us going forward.

Thirdly, I'll comment on the funding situation. In Q1, we substantially increased the number of funding partners. Most of the additions are national financial institutions that can do business across the country. I think it's -- from what we can see our need for the year are multiple times covered by the national financial institutions by now. Through our internal stress testing, even the rumored restriction on regional banks' ability to disburse loans nationally came into effect immediately, our funding availability and the funding cost shouldn't be adversely affected. We're very pleased to report that on February 1, we issued our first ABS at Shanghai Stock Exchange at a funding cost of approximately 5%. In Q1, we gained approval for CNY 10 billion of such securities in 2019 at both Shanghai and Shenzhen Stock Exchange. Thanks to the stimulating financial and the liquidity environment in China. We observed downward trend in funding costs with our financial institution partners and believe the trend will materialize into noticeable funding cost reduction in Q2 and the rest of the year.

Lastly, I want to comment on the strategy of a shift to financial technology platform. The percent of loans we don't take credit risks has risen significantly in Q1 and we expect this will further increase significantly over the rest of the year. We referred over 3 million customers to banks, consumer finance companies and other lending platforms in Q1 where we do not taking any credit risks. We launched 4 financial technology products and covered credit scoring propensity to borrowing scores, credit hungry scores and a blacklist checking. This is a part of our efforts to open our capabilities to third-party lenders. 15 institutions are testing the product at the moment, including banks like ICBC.

So with that, I'll pass to -- the call over to Alex Wu, our CFO, to give an update on the financial situation.

Jiang Wu *360 Finance, Inc. - CFO*

Thank you, Jun. Hopefully, you all have the -- have had a chance to take a look at our earnings release already. So I will try to keep my comments short so we have more time for the Q&A. As Jun just mentioned, we saw 235% growth on our top line on a year-over-year basis, 303% growth in operating income and 335% growth in our non-GAAP operation income, 3% -- 340% growth in our net income and 382% growth in our non-GAAP net income. So not only are we growing extremely quickly, we are also gaining more operating leverage as we continue to scale our business. Breaking this down a little bit more, our total net revenue was mainly driven by loan facilitation services, which increased 248% compared with the first quarter of 2018. The rise was mainly due to an increase in loan origination facilitated by our platform, which increased 179% for the same period last year and increased 25% from last quarter. In terms of the cost structure, it mainly includes 3 items: origination servicing, sales marketing and G&A expenses.

Given all the numbers disclosed in the report, let me just give you a little bit of a flavor on the details. The percentage of the operating and servicing expense, obviously excluding share-based compensation over revenue, was 10.6% compared to 14.1% last quarter. And the percentage of G&A expense, excluding SBC over revenue, was 2.4% compared to 2.7% last quarter. This speaks to our increasing operating efficiency, while the percentage of sales and marketing expense, excluding share-based compensation expense over revenue, was 34.3% compared to 30.1% last quarter. The increase of this percentage was due to -- was because we view our sales and marketing expense more of a long-term investment, since each new customer to our platform will continue to our business -- contribute to our business on a ongoing basis. In terms of margins, our non-GAAP operating margin in the first quarter was 46.2%, which is a solid improvement from 35.6% in the first quarter of last year. Our net margin in the first quarter was 35.8%, which was higher than the 27.3% level we hit in the same quarter last year. On a non-GAAP base, when we take out the share-based compensation that I mentioned earlier, our net margin goes up to 39.3% for first quarter. Again, this number speak to not only the greater economics of scales we -- as we grow our business, but also the hard work we have put in to streamline our operations and improve efficiency.

And finally, moving over to the balance sheet. Our total cash stands at CNY 3.4 billion, including cash, restricted cash and the security deposits prepaid to the third parties. Our total cash increased 20% compared with the number by the end of 2018, which provides a solid foundation for -- to our growing business and daily operation. One other item -- line item that I would like to point out is our loan receivables. This jumped from CNY 888 million at the end of the year to CNY 1.9 billion by the first quarter of this year. This was mainly because we increased our cooperation with trust and issued ABS to diversify our funding sources, as Jun mentioned, and we do plan to issue more ABS in the future. All in all, we believe we have a very solid financial performance that gives us both a substantial cushion and significant firepower as we expand our business.

With that, I'll conclude our prepared remarks and we would be happy to take your questions now.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question today comes from Joey Xu with Morgan Stanley.

Joey Xu *Morgan Stanley, Research Division - Research Associate*

I basically have 3 questions. The first one is regarding to the cash management. I noted a decrease of CNY 106 million cash balance in the first quarter. Does the management see some further decline, maybe in the next few quarters? Or does the company have a internal mandate cash ratio as a percentage of total loan balance or something like that? And the second one is regarding to the take rate. We -- our calculated take rate shows some improvement in first quarter, as the management mentioned it's because of the higher facility and service fee and post-origination service fee and et cetera. I just wanted to ask if there is any change on the product pricing, funding cost or credit cost front? And the third one is on the acquisition front -- customer acquisition front. We noticed a 70 -- CNY 700 million sales and marketing expenses in the first quarter and just wanted to check if the management's outlook on the customer acquisition going forward both on the cost and acquisition channel front?

Jun Xu *360 Finance, Inc. - CEO & Director*

Okay. So on the cash position, Alex, would you like to take that.

Jiang Wu *360 Finance, Inc. - CFO*

Sure. Thanks, Joey. This is very good question. Actually, we want to address that. As I mentioned in our remarks, when you read our cash position, you should look at 3 items. The first item is the cash and cash equivalent, the other one is restricted cash and the third one is the security deposit prepaid to third-party guarantee companies. Basically, all these 3 items are our cash. The reason they're put in a different category just because our business nature for -- in a rough sense, for $100 loan origination, we need to put in $5 as some kind of a deposit to the institution working with us. So it's not a cash position decrease it being the past quarter, it's in total actually increased by 20%. Just most of the cash went into the restricted cash and security deposit prepaid to third-party guarantee companies. Hopefully, I -- this will answer your question.

Jun Xu *360 Finance, Inc. - CEO & Director*

Yes. On the take rate and the pricing funding cost, credit cost. Overall the pricing and the funding cost has remained very -- quite stable compared to the previous quarter. The credit cost actually has improved over the previous quarter and is below our expectation for Q1. So net-net, we see the APR has been stable. Funding cost, as I mentioned earlier, is trending down and we will see some noticeable numbers in Q2 and the rest of the year hopefully. And credit cost were positive, will stay stable and remain well below our internal budget. I'll pass to our President, Wu Haisheng, to address your question on cost and acquisition.

Haisheng Wu *360 Finance, Inc. - President*

(foreign language)

Jun Xu *360 Finance, Inc. - CEO & Director*

Our General Counsel, Fan, will translate for Mr. Wu.

Fan Zhang ***360 Finance, Inc. - Director***

We are within a enormous consumer credit market. We have potentially billions of users and right now we are only in a position of acquired over 10 million users. Honestly, we still think we are in the early stage of development, and as our CEO mentioned, our headroom for growth is immense. Our return on investment and customer retention is looking very good. What we believe is our current expenses, spending on marketing, is a long-term investment for the future. And our -- to our outlook for cost of customer -- new customer acquisition, I think we're going to -- our future spending is going to be in line with -- we just mentioned our belief in the future. As to new channels, we are exploring different new channels on the basis of utilizing our current channel. We are keeping a very open minded, right now we are exploring several new channels some of which are looking very promising. For example, our experiments with Kuaishou and Tencent channels has become very effective. Also, we are exploring in the -- in e-commerce platform.

Operator

Our next question comes from Jiang Zhang with China Renaissance.

Jiang Zhang ***China Renaissance Securities (US) Inc., Research Division - VP***

Congrats on a good quarter. So I've got two questions. One is -- regards to the mix of the institutional funding partners. So within that, like how much of that is national and how much of that is regional financial institutions? And the second question I have is, can you just provide more color on the ABS products, give us a sense of, like, what kind of scale are you guys are looking to achieve in the next 2 to 3 years?

Jun Xu ***360 Finance, Inc. - CEO & Director***

Okay. Thanks. In terms of institutional funding, what we will look at is not the actual composition, what we focus on is among all the funding partners working with us now, how many of them are national and how many of them are regional. As I said earlier, from what we can see now, our demand for funding this year are multiple time covered by national FIs who have relatively lower cost of funding. So unless something dramatic happens to the overall financial and liquidity situation in China, we're pretty positive about our funding availability and funding cost for the rest of the year, as I said earlier, the funding cost are trending down, and we'll be able to report some actual numbers going forward. In terms of ABS, for this year we've gained approval for CNY 10 billion ABS issuance with Shanghai and the Shenzhen Stock Exchange. We're also, in the meantime, discussing ABNs. ABN is another form of ABS that's issued on the interbank market. So for this year, we're looking at, at least CNY 10 billion. And going forward, we would like to make ABS a much more important source of funding as our assets become more well known to the institutional investors. So we do anticipate ABS, as a source of funding, will become much more important for the next 2 or 3 years.

Operator

(Operator Instructions) Our next question today comes from Daphne Poon with Citi.

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

So first I would like to, actually, have a follow-up on the sales and marketing expense. So if we look at it on a per new user basis, we see that actually has gone now close to CNY 200 per new user, based on our calculations. So I'm wondering if that is -- you see that as more of an industry trend because of increasing competition or is this more because you're doing a more aggressive customer acquisition, actually, [in auto]. And second is on the vintage delinquency rate. So if we look at the vintage loss rate for the 2Q 2018 cohort, we actually see the curve has gone up a little bit steeper, while we see the loan duration is actually pretty stable. So I'm wondering like how should we interpret that or any particular reasons behind. And third, lastly, is on the -- other than the last quarter, we talked about our new initiative on the SME lending, like primarily with some banks, so wondering if there's any update on the progress on that front?

Jun Xu ***360 Finance, Inc. - CEO & Director***

Okay. I'll start with the first two and I'll ask Alex Wu, our CFO, to answer your third question. On customer acquisition cost, yes, it has gone up a little bit, it's within our budget, it's also in line with our observation of the rising acquisition cost across the market and, in particular, this year as funding situation has improved for the sector, we see more competition on the traffic front. But, again, if you look at the return on investment, we're still very, very positive about this kind of spending and this is actually below our internal budget in terms of customer acquisition cost, unit cost.

On the delinquency rate, it's not that our risk has deteriorated, it's driven by a shift in mix of our portfolio, as I mentioned. As we gained more confidence and experiences with our credit model, we increased the share of near-prime customers where we price them close to 36 APRs as a percentage of the portfolio. And as I mentioned, although their charge-off rate is a little bit higher, but APRs more than offset that effect. So if you look at the same pricing cohort, as I mentioned earlier, the credit cost actually has improved in Q1 compared to the previous quarters.

Alex, can you take SME question?

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

Yes. So in the past quarter, we were still testing this product. We basically focus -- right now, we have the focus on the existing borrowers, where we check their behaviors and see whether they are more like SME or more like individual. That is our key pilot product at this moment. In the meantime, we are trying to find more scenarios and to get more familiar with different scenarios and help the small SMEs in that specific scenario to increase their business skills. Overall -- given that there was no numbers disclosed in our quarterly report, we can't disclose any details, but -- and what we can say is in this small business -- the SME business is on the right track. We will give you more updates when it is material enough to show its individual status.

Operator

(Operator Instructions) As there are no further questions at this time, this concludes our question-and-answer session. I would like to turn the conference back over to George Shao for any closing remarks.

George Shao ***360 Finance, Inc. - Head of IR***

Okay. That concludes our call for today. So thank you for joining this conference. So please don't hesitate to reach out to us directly if you have any further questions. So thank you all.

Jun Xu ***360 Finance, Inc. - CEO & Director***

Thank you.

Operator

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