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Q4 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 Fourth Quarter and Full Year 2022 Earnings Conference Call. (Operator Instructions) Please also note that today's event is being recorded.

At this time, I would like to turn the conference call over to Ms. Karen Ji, Senior Director of Capital Markets. Please go ahead, Karen.

Karen Ji ***360 DigiTech, Inc. - Senior Director of Capital Markets***

Thank you, operator. Hello, everyone, and welcome to 360 DigiTech's Fourth Quarter and Full Year 2022 Earnings Conference Call. Our earnings release was distributed earlier today and is available on our IR website. Joining me today are Mr. Wu Haisheng, our CEO; Mr. Alex Xu, our CFO; and Mr. Zheng Yan, our CRO.

Before we start, I would like to refer you to our safe harbor statement in the earnings press release, which applies to this call as we will make certain forward-looking statements. Also, this call includes discussions of certain non-GAAP financial measures. Please refer to our earnings release, which contains a reconciliation of the non-GAAP measures to GAAP measures. Also, please note that unless otherwise stated, all figures mentioned in this call are in RMB terms.

Now I will turn the call over to our CEO, Mr. Wu Haisheng. Please go ahead.

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

[Interpreted] Hello, everyone. Thanks for joining our Q4 2022 earnings conference call.

On the macro environment front, we experienced a volatile quarter in Q4 swinging from widespread lockdowns across China in October and November to the border reopening and the cancellation of almost all COVID-19 restrictions in December. This concluded nearly 3-year period of strict COVID control policies in China. Regulatory authorities also announced that the rectification of financial business within the major Internet platform companies has been mostly completed. At a meeting held on February 27, 2023, the China Banking and Insurance Regulatory Commission, CBIRC, called for proactive coordination between financial, fiscal and social policies to provide greater support for the growth of private consumption and domestic demand in China.

The Financial Market Department of the People's Bank of China, PBOC, also pledged to facilitate the healthy development of the platform economy in 3 ways, including speeding up the rectification of the remaining minor issues with some Internet platform companies, improving standards for regular supervision and developing financial measures to support the sustainable healthy development of the platform economy. Our industry is, therefore, headed in a more positive direction.

As of the end of Q4, we have partnered with a total of 143 financial institutions for our loan facilitation business. Total loan origination and facilitation volume was RMB 104.6 billion, up 8% year-over-year. As of the end of Q4, cumulative number of users with approved credit lines reached approximately 44.5 million and cumulative borrowers with successful drawdowns reached approximately 27 million, up by 16% and 11% year-over-year, respectively.

Last Q4, China implemented its most extensive COVID control measures since 2020. While in December, the government adjusted its COVID policies in a massive wave of infections subsequently occurred across China. Given the uncertainties posed by both the COVID and the initial period of reopening, we tightened our customer acquisition and credit assessment policies in Q4. These, together with the optimization of our user base, have helped improve our day-1 delinquency rate from 4.5% in Q3 to 4.3% in Q4, the lowest level since 2018. Despite the volatility in our 30-day collection rate due to the COVID resurgence, our overall risk performance remained stable. With our user base upgraded, our pricing also stabilized. The average IRR of the loans we originated and facilitated during this quarter was flat sequentially.

We scaled back our marketing efforts given our concerns about the credit risk associated with the COVID. Meanwhile, we continued to upgrade our RTA model and improved our capabilities and efficiencies to acquire targeted users. In Q4, the acquisition cost per new user with the credit lines decreased by approximately 24% sequentially. We further expanded and diversified our customer acquisition channels by working with different types of traffic platforms, including short- and long-form videos, social media, search engines and food delivery platforms, et cetera.

In terms of cooperation with financial institutions, liquidity remained ample in the financial system during Q4, leading to strong demand for high-quality assets by financial institutions and a further reduction in our funding costs. As of the end of Q4, we had established a long-term partnership with 143 financial institutions, including over 10 joint stock banks and major urban and rural commercial banks with AUM of more than RMB 1 trillion, allowing us diversified funding sources. Our funding cost decreased by roughly 20 basis points sequentially. For ABS issuances, we issued RMB 1.8 trillion -- sorry, RMB 1.8 billion in Q4 at an average funding cost of 5.4%. There was some unusual level of volatility in the bond market in the quarter. While some industry peers cancelled ABS issuance on a large scale, we continued to issue at a relatively stable price.

We also made steady progress on the "credit agency reform", namely "Duanzhilian" in Q4. As of December 31, 2022, we had substantially completed the system integration with our financial institution partners under Duanzhilian in accordance with our plan submitted to the regulator to ensure our practices comply with the new rules. Our loan facilitation process with these partners remained stable in terms of both credit approval rate and key risk metrics.

Given the macro challenges and COVID control measures, China's consumer finance and SME credit markets faced headwinds on both the demand and risk fronts in 2022. Against this backdrop, we sticked to our prudent operating strategy and leveraged technology to drive quality growth. In 2022, total loan origination and facilitation volume was RMB 412.4 billion, up 15.5% year-over-year and in line with our guidance at the beginning of the year. We made solid progress in optimizing our user base, allowing us to weather the macro headwinds and stabilize our asset quality. Our D1 delinquency rate decreased by more than 1 percentage point to 4.3% in Q4 from 5.4% in the same period last year, highlighting the resilience of our business.

In light of the volatile macro environment, we kept the percentage of loans originated and facilitated under our capital-light model, ICE and other tech solutions relatively stable at roughly 56% in 2022. These business models have provided us with more flexibility and a means to balance risk. We also maintained disciplined cost control and optimized our operational efficiency during the year. As such, we achieved our targeted net take rate for our baseline business despite the decline in loan pricing.

We remain committed to fulfilling our social responsibilities as we operate our business. In 2022, we served a total of 910,000 self-employed individuals and 1.08 million business owners, supporting about 6 million jobs.

Given the gradual resumption of economic activities since the start of 2023, we have seen a modest recovery in credit needs and a notable improvement in our asset quality. Our D1 delinquency rate in February decreased further to 4.1% while the 30-day collection rate quickly recovered to last Q3 level, showing a faster-than-expected improvement in our risk performance. Now let me share with you some of our priorities for 2023.

First of all, the continued reduction in our credit cost and funding cost has created favorable conditions for us to better serve our users. We have approximately 44.5 million cumulative users with approved credit lines. How to effectively convert them into borrowers and increase the credit utilization of our existing borrowers will be crucial to drive our overall growth. To enhance our engagement with inactive users, we will step up our marketing and outreach efforts while optimizing our product mix and risk control strategies. We will also seek to improve our user retention rate for existing borrowers by refining our operations to offer them with the products and the user experiences that better serve their needs.

We will continue to diversify our customer acquisition channels. We have already established a clear competitive edge in the customer segment with borrowing costs from 18% to 24%. Meanwhile, there are many traffic platforms that have large diverse user bases, but lack the expertise to engage with users in our target segment. As we adjust our overall loan pricing to below 24%, our embedded finance business will be able to cover more leading traffic platforms. We expect more strategic partnership to be launched later this year.

We will explore market opportunities to serve a broadly defined SME segment, including SMEs, SME owners, entrepreneurs, self-employed individuals, etc.. Public data shows consumer demand in certain sectors has recovered quickly since the Chinese New Year. The recovery in private consumption will improve the credit demand and repayment ability of the broadly defined SME segment. To capitalize on these opportunities, we will develop targeted products to better serve their credit needs. Approximately 30% of our current user base are broadly defined SMEs, whose outstanding loan balance only accounts for roughly a little bit higher than 30% of the total. This leaves substantial room for growth.

In terms of the tech solutions business, we already deepened our operation with financial institutions through our end-to-end technology solutions. This will enable us to generate more risk-free revenue, serve a greater number of high-quality users with lower pricing through our bank partners and expand our total addressable market. This year, we will focus on extending the depth of our tech solutions services to improve our take rate. With these services in place, we believe that our tech solution business will improve in terms of both loan volume and revenue quality.

Finally, I would like to conclude my prepared remarks with a few more thoughts. Our company is still very young, having only been around for over 6 years. The sector that we are in is also at the very early stage of its lifecycle. Our team is young and motivated, and our initial entrepreneurial dream has just begun to materialize. We desire to deliver far more brilliant results than what we have achieved today. We believe that 2023 will be a good year for us, thanks to the supportive government policies and a recovering macroeconomy, combined with our sound strategies and unique positioning. Although the macroeconomic rebound has not been very robust so far in the first quarter, we have great confidence that 2023 will be a year of growth. As we continue to improve our risk performance, expand our customer acquisition channels, optimize our funding costs and improve our services to broadly define SMEs, we expect a fruitful year ahead.

With that, I will now turn the call over to our CFO, Alex Xu, who will walk you through our financial results for the quarter and full year.

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

Thank you, Haisheng. Good morning and good evening, everyone. Welcome to our fourth quarter earnings call. As Haisheng discussed earlier, we delivered another solid quarter in a very challenging macro environment. COVID outbreaks and restrictions created additional headwinds to our operations during the quarter, particularly in December. However, since the reopening in early January, we have experienced some modest pickup in demand for consumer credit, while asset quality noticeably improving.

In Q4, we continue to target higher quality and lower risk user base and drive further improvement in user quality despite significant macro uncertainties. Key leading indicators, day 1 delinquency has been on a steady declining trend throughout 2022. It was 4.3% in Q4 versus 4.5% in Q3 and further declined to approximately 4.1% in February. To this day, the declining trend continued on a gradual basis. The continued improvement in day 1 delinquency reflects the user base upgrade and macro improvement in the new year.

30-day collection rate was 84.7% in Q4 versus 86.4% in Q3. This was mainly due to disruption of our collection operations and the deterioration of consumer confidence following the tightening COVID restrictions in November and the surge in COVID cases in December. As the COVID pace peaked in late December and the reopening progressed, by early February, 30-day collection rate has quickly recovered to above the Q3 level.

Total net revenue for Q4 was RMB 3.9 billion versus RMB 4.1 billion in Q3 and RMB 4.4 billion a year ago.

Revenue from credit service -- credit-driven services [capital-heavy] was RMB 2.8 billion in Q4 compared to RMB 2.9 billion in Q3 and RMB 2.7 billion a year ago. The slight year-on-year growth was mainly due to growth in on-balance sheet loan volume as we achieved better utilization of our micro lending license.

This solid performance was more than enough to offset decline in average pricing of the loan and the decrease in off-balance sheet facilitation volume. Off-balance sheet facilitation revenue take rate declined sequentially due to a year-end adjustment of early repayment discount. On a year-on-year basis, the take rate declined slightly despite significant price cuts in 2022.

Revenue from platform service [capital light] was RMB 1.1 billion in Q4 compared to RMB 1.2 billion in Q3 and RMB 1.7 billion a year ago. The year-on-year decline was mainly due to decrease in volume and average prices of capital-light loan facilitation. Q4 and full year 2022 capital-light loan facilitation, ICE and other technology solutions combined accounted for roughly 56% of the total loan volume. As macro conditions gradually improve in 2023, we will try to strike an optimal balance between risks, growth and profitability. As such, contribution from capital light, ICE and other technology solutions will likely be range- bound in the near term. In the long run, we'll continue to pursue tech-driven business models while seeking a balance among various forms of non-risk bearing solutions based on macro environment and operational conditions.

During the quarter, average IRR prices of the loans we originated and/or facilitated remained stable Q-on-Q, well within the regulatory rate cap requirements. Looking forward, we expect pricing to be relatively stable for the coming quarters. Sales and marketing expenses decreased by approximately 34% sequentially in Q4. During the quarter, we lowered the pace of new user acquisition as we focus more on existing users' engagement given the extremely challenging macro conditions. We added approximately 1.5 million new credit line users in Q4 compared to approximately 1.7 million in Q3. Unit cost to acquire a new credit line users declined approximately 24% sequentially.

The declined consumer acquisition -- customer acquisition costs mainly reflect our continued efforts to drive efficiency in our operation as well as the soft demand in muted economic activities. As macro conditions gradually improve in 2023, we may also adjust the pace of the new user acquisition along the way. Meanwhile, reenergizing existing user base will continue to be a main driver for our growth. As always, we will continue to use lifecycle ROI and LTV as key metrics to determine the pace and scope of our user acquisition strategy to ensure the sustainability and the profitability of our operations.

Overall risk profile of our loan portfolio remained stable in Q4 as increased contribution from new loans from high-quality borrowers offsetting negative impact on old loans by macro uncertainties. Although macro condition appears gradually improving, it may still take some time to be reflected in the consumers' behavior. As such, we continue to take a prudent approach in booking provisions against potential credit loss. Total new provisions for risk-bearing loans in Q4 were approximately RMB 1.7 billion, and the writebacks of previous provisions in the quarter were marginal. Provision coverage ratio, which is defined as total outstanding provisions divided by total outstanding delinquent loan balance between 90 and 180 days were 456% in Q4 compared to 406% in Q3.

With solid operating results and a stable contribution from capital-light models, our leverage ratio, which is defined as risk-bearing loan balance divided by shareholders' equity was at a historical low of 3.5x in Q4 compared to 4.3x a year ago. We expect to see rather stable leverage ratio for the time being until capital light contribution resumed growth in the future.

We generate approximately RMB 1.8 billion cash from operations in Q4 compared to RMB 1.6 billion in Q3. The sequential increase in operating cash flow was mainly driven by better working capital management. Total cash and cash equivalents was RMB 10.9 billion in Q4, essentially flat Q-on-Q. Non-restricted cash was approximately RMB 7.2 billion in Q4, also flat sequentially.

In the last few quarters, we took more conservative approach to deploy our cash in day-to-day business, mainly due to macro uncertainties. As economic conditions improve, we may look for opportunities to deploy resources to launch new initiatives, develop new technology and expand service offerings.

Non-GAAP net profit was RMB 919 million in Q4 compared to 1.04 billion in Q3. Non-GAAP net income for 2022 was RMB 4.21 billion. As we continue to generate healthy cash flow from operations, we believe our current cash position is sufficient to support our business development and to return to our shareholders. In accordance with the dividend policy approved by our Board, we declare another quarterly dividend of USD 0.16 per ADS for Q4.

Finally, regarding our outlook for 2023. 2022 was an extremely challenging year in terms of macro conditions. While we start to see tentative signs of economic recovery in the new year, the lingering economic impact from the past on consumer confidence and behavior may still last for a little bit. At this junction, we see modest recovery in consumer credit demand with growth rate potentially accelerating throughout this year. As such, we expect total loan volume for 2023 to be between RMB 455 billion and RMB 495 billion, representing year-on-year growth of 10% to 20%. As always, risk forecast reflects the company's current and preliminary view, which is subject to material change.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) First question comes from the line of Judy Zhang from Citi.

Judy Zhang ***Citigroup Inc., Research Division - MD & Head of China Banks & Brokers Research***

[Interpreted] I will translate my question. So, thank you, management, for giving me the chance to ask a question in the first place. And my question is regarding the credit demand. How significant the credit demand recovery do you see since the reopening? And what's the main reason for not seeing a strong recovery? And also, we saw the management give a relatively conservative loan origination growth guidance for this year, which is like a 10% to 20% year-on-year growth, which is below the loan volume growth guidance like last year, which is 15% to 25% year-on-year growth. What's the key reason behind?

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

[Interpreted] In terms of the credit recovery, actually, we have seen some surge of our consumer behavior recovery right after the reopening. And we also see a modest recovery in credit needs. But if we look at different sectors, we have seen some sectors leading the recovery. For example, the restaurant and the tourism, but some of the industries are lagging behind. So we believe it takes some time for the outlook for employment and personal income to eventually benefit from the recovery of consumption and boost the credit demand recovery. So it's not right now for the credit demand to recover from the -- yes, to have an immediate recovery for our credit needs. And although the recovery in credit need is not so robust in the recent 2 months in Q1, we believe that Q2 and Q3 will be better.

In terms of our guidance, actually, we are a company sticking to our promise. We won't allow the situation we cannot deliver our promise. Even in the extreme situation last year, we still sticked to our initial guidance in the beginning of the year, and actually, we delivered that. So in terms of the guidance for this year, we think it's within the market expectation, and we take and tend to take a prudent view for the pace of our loan volume growth in this year. And we believe if the market situation, the macro economy improved further in later this year, we will also adjust our growth pace. And we believe this year will be for the -- loan volume and the growth rate will be gradually ramping up in the year. And this year will be a good year for us. I hope this answers your questions, Judy.

Operator

Next question, we have the line from Yada Li from CICC.

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

[Interpreted] Then I will do the translation. This is Yada from CICC. During the COVID pandemic, we noticed that you pay more attention to the operation of existing users in terms of the customer acquisition side. And therefore, the new loan sales were partly from the premium existing users. And I was wondering if the marketing budget will increase in 2023 and 2024? What kind of customer acquisition strategy will you adopt in the future? And what are the main factors that determine whether to increase the marketing budget? That's all.

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

[Interpreted] Thanks, Yada, for your questions. I want to highlight the major growth driver for our business. Actually, we have over 40 million users with approved credit lines and over 20 million borrowers. So you can see that we have over 20 million users who never borrowed the money from us. In terms of new customers, actually, we have 3 million to 4 million new customers acquired basically every year. So it's very crucial for us to spend more time making more efforts in terms of engaging our existing users. And we believe this will be a major driver for the growth of our companies in the future.

From a marketing budget perspective, actually, we allocate the budget to existing users and new users. For new -- for existing users, we will spend money to reach out to them and use some offers to call back the uses some better offers to call them back. And we will also improve the user experience of those broadly defined SME borrowers to keep them active on our platform. So we will keep our budget for the engagement of all the users, our existing users.

Okay. For the new users, we will expand our network to cooperate with more platforms in terms of the embedded finance business model. Because our pricing is already below 24%, it brings us opportunities to connect with more quality platforms to serve a larger number of customer base. In terms of market spending, considering the recovery -- credit need recovery in terms of the users' activeness, Actually, first, we will prioritize our work to increase the credit utilization for those new users first. And then we will consider to expand our marketing spending to acquire new users. I hope it clarifies your question.

Operator

Next question, we have the line from Thomas Chong from Jefferies.

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

[Interpreted] My question is about competition going into the field in terms of the pricing side, how should we think about the competition with banks or short-form video?

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

[Interpreted] First of all, we think we are quite differentiated from the traditional banks and the large Internet platforms in terms of the pricing. Actually, we enjoy an absolute competitive edge in terms of serving the pricing segment between 18% to 24%. So we don't believe that we will have a head-to-head competition with those large platforms or traditional banks. On the contrary, we think we can provide additional value to them by operating with those platforms.

So because of these differentiation points, we realize that a lot of Internet giant platforms want to expand their outreach to different types of customers. Because of our core competence, we can help them to expand their customer base and increase their credit product, the loan volume to serving their credit product to their users. So we believe this is what we can -- the additional value we can provide to those platforms. Yes. I hope this answers your questions, Thomas.

Operator

Next question comes from the line of Hans Fan from CLSA.

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

[Interpreted] So this is Hans Fan from CLSA. I got a question related to the loan outlook because the management was mentioning about this year is going to be better part in the second half. So I was wondering that what's the sort of lending pace across different quarters? And also in terms of the split between capital heavy and platform services, how do you think that split this year? Do we have a target for the split in the longer run?

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

[Interpreted] In terms of the quarter-on-quarter loan facilitation pace, we expect it will ramp up throughout the year, which means the loan volume will grow quarter-by-quarter because we believe the credit needs will benefit from the recovery of the consumers' behavior. So the loan volume in the second half of this year will be increasing compared to the first half.

Okay. In terms of the contribution from our asset light or the platform service business model. First of all, we believe this is our long-term strategy to develop our platform service business model because we always position ourselves as a fintech company. So in the long run, we believe the loan volume contribution from the capital light will further increase. But if we look at the short-term, we will actually adjust the loan contribution -- loan volume contribution from the asset light business model based on our assessment of the macro environment and credit risk associated with the macro. In terms of -- and we want to -- we will adjust the contribution to balance the risk and the profitability of our business.

We believe this year will be a stable year, and we want to achieve a healthy profitability for our business. So this will be an overall judgment. We expect the overall contribution from the capital light business to remain stable in this year. But in the next step, we will further develop our tech solutions business because it's a pure tech business model. So as our customer base grows, our loan volume will also increase. And we expect the contribution from the capital light or platform service will further increase in the future.

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

Hans, I just want to add a couple of points regarding the growth rate for this year. We noticed that in the recent few days, some of the companies related to the consumer market report their earnings they gave a pretty somewhat disappointing outlook for the first quarter in terms of year-over-year growth. And we look at it, although last year, Q1 was a relatively normal quarter, meaning there's not really much disruption in operations in the last year's Q1, the comp is not that easy. But even with that kind of not easy comp, we are expecting year-over-year growth in terms of volume right off the slate of this year. And then along the way, as we move forward for the remainder of the year, as Haisheng mentioned, we may see a gradual acceleration of growth quarter-by-quarter on a year-over-year basis. That's the point I want to add.

Operator

In the interest of time, we will now take the last question. Lastly, we have the line from Alex Ye from UBS.

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

[Interpreted] So I will translate my question. I have 2 follow-ups on your loan guidance for this year. So if we look at the midpoint of your guidance of 15%, can I ask what are the underlying assumptions here? For example, would you still brand the consumer credit recovery as a modest one? And do you need to increase your risk appetite in order to achieve this new point target? And secondly, for the higher end of our target at 20%, I'm just wondering what are the things or data points you need to see for you to be more comfortable to go forward to that higher end? And what are the drivers?

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

[Interpreted] Okay. I will forward this question to our CRO, Zheng Yan.

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

[Interpreted] Okay. From risk appetite perspective, we will take a prudent credit assessment approach in this year. So we can see the further improvements in our risk performance in 2023. For example, our Day 1 delinquency rate in February has come down to 4.1%. And the 30-day collection rate also recovered to a level -- the highest level in last few years. In this February -- in February. And we believe in March, those 2 indicators will further improve. So in this year, overall risk performance will be better than last year.

Our guidance is based on the assumption that the recovery of the macro environment will improve. The outlook for the employment and the personnel income will eventually benefit the credit need recovery. And at the same time, we believe there is an assumption that our risk performance will continue to improve down the road. So this year, if things are getting better, for example, the recovery of the credit needs and the risk performance accelerate this year, we will also consider adjusting our growth pace.

Operator

With that, I would like to hand the call back to the management for closing.

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

Okay. Thank you, again, everyone, for joining us for the meeting. And if you have additional questions, please feel free to contact us off-line. Thank you. Bye-bye. Thank you.

Operator

That does conclude today's conference call. Thank you for your participation. You may now disconnect your lines.

[Statements in English on this transcript were spoken by an interpreter present on the live call.]