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Q1 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 First Quarter 2022 Earnings 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 ***360 DigiTech, Inc. - IR Director***

Thank you. Hello, everyone, and welcome to our first 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 statement 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, all 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***

[Interpreted] Hello, everyone. I'm very happy to report a strong start to 2022. In Q1, total loan origination and facilitation volume reached RMB 98.8 billion, up 33% year-on-year and 2% Q-on-Q. Outstanding loan balance reached RMB 146.7 billion, up 44% year-on-year and 3% Q-on-Q. Despite the seasonal impact from the Chinese New Year and the macro and COVID headwinds, our solid performance continued to demonstrate the resilience and flexibility of our operations.

I reckon the major concern to the market right now is the COVID outbreaks. To deal with the situation, we created precautionary plans and took rapid response measures to make the impact on our business under control. Such an effective response derived from our successful experience handling the pandemic that hit Wuhan back in 2020. Back then, our response was seen as very timely and effective in the industry.

As the COVID resurgence in Q1 in a number of Chinese cities, our team moved fast and implemented a range of pre-emptive counter measures. For example, we launched a multi-tiered pandemic alert system for the cities that are key to our business. In addition, we strategically scaled back our business for high-risk customers in the industry hard hit by the outbreaks, such as recreation and hospitality. Meanwhile, we proactively communicated with major funding partners about potential extension for loan repayment. For borrowers who are unable to make repayments on time or lost the capacity to repay in the near term due to COVID, our customer service team stepped in and helped them to apply for repayment expansion. In the cities severely affected by the lockdown, it was very difficult for our offline team to acquire new customers. In such cases, we quickly shifted our team focus from offline customer acquisition to serving existing customers. This allowed us to uphold the morale and sustain business performance.

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Thanks to the effective measures to mitigate the impact from COVID and our strategy to optimize customer base, we successfully kept the impact to our asset quality under control. In the first half of this year, we are working to upgrade our customer base. This includes to acquire more high-quality users, pivoting resources to better serve high-quality users and reducing exposure to high-risk borrowers. With these measures in place, the percentage of our category A users, those with the best credit profiles, greatly increased from budgeted level.

Our first payment default rate 30 days, which represents the percentage of our first payment default for 30 days, for new loan origination also dropped Q-on-Q. At the same time, we upgraded our Cloud Bank System, which connects consumer demand with institutional offerings through smart matching, and meaningfully improved asset quality of online loan facilitation segment. For example, expected vintage loss rate decreased to 2.4% to 2.7% recently from 2.83% in Q4 last year.

The credit quality of our new customers in Q1 was better than any of our previous quarters. Even with the impact of COVID, risk performance was significantly better than last year, and we believe it will continue to improve. Although there was some fluctuation for the asset quality of our existing loan book due to COVID, the overall impact is still within the control. Currently, the day 1 delinquency rate of existing loan book is 4.97%, better than last year and at a relatively low level on record.

Our collection rate dropped in Q1 with significant drops in the lockdown cities such as Shanghai and Jilin. However, we noticed that by May, the collection rate has stabilized in these regions and it started to improve nationwide. As our user base continues to optimize, our risk performance will keep improving gradually.

In Q1, our offline operation was restricted in some cities under COVID lockdown, such as Jilin. The lockdown temporarily put some pressure on offline user acquisition. The overall impact of our online user base was limited, although we do notice some were less willing to spend in the challenging environment. Even in Jilin, which has relatively long lockdown, our total transaction volume only showed a small decrease compared to the pre-lockdown level. Currently, most municipal districts in Shanghai have reached zero COVID at the community level, and the businesses are expected to resume operations in the near future. As such, our operations in these regions are likely to gradually return to normal.

Although COVID-related uncertainties are likely to persist throughout this year, with the set of counter solutions we have deployed over time and our enhanced ability to effectively respond to new outbreaks, we are confident that we will continue to keep the impact of the pandemic to a manageable level.

Next, let me provide an update on industry policies, which the market follows closely. We have seen positive top-down policy developments for the industry. On April 29, a political bureau meeting pledged support for healthy development of platform economy and to complete special rectification measures for the platform economy. PBOC and CBIRC made similar comments at the following special meetings. Both regulators vowed to complete rectification of financial operations of platform companies, implement normalized supervision and support healthy development of the platform economy.

This signals that the current rectification of the industry is close to an end. Related internet platform companies will complete rectification process under the guidance of financial regulators and will be under regular provision afterwards. After over a year-long rectification, these companies will be the first in the industry to be fully compliant and will be well positioned to develop in a healthier and more sustainable framework.

At the industry policy level, in early April this year, the PBOC and SAFE jointly issued the Notice to Enhance Financial Services to Support Pandemic Control and Economic and Social Development. The document mentioned leveraging the benefits of financial services provided by Internet platform companies, while promoting the disciplined and healthy development of such services. This is a recognition by the financial regulators of the positive role Internet platform companies play in financial services.

On the business front, our strategic focus this year is the structural optimization of our user base and funding sources to enhance user lifetime value and increase the sustainable contribution of high-quality funding, therefore further improve our operational resilience. In Q1, we achieved noticeable progress in some key areas.

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On the funding front, we continued to optimize our funding structure. First, we ensured a sufficient funding supply to support business growth. Second, we continuously optimized the funding cost and the contractual terms with our funding partners as our high-quality assets are in high demand by financial institutions. Third, we expanded funding partnerships with joint-stock banks and major urban and rural commercial banks, which have broader regional coverage and strong funding supply. Such expansion will prepare us to better serve business growth and deal with economic uncertainty. So far, we have connected with approximately 70%, 7-0-percent, of nation-wide financial institution. We will soon add 3 more national joint banks or private banks into our partnership and have another 7 in the pipeline.

At the product front, we have followed the regulatory guidance closely. Specifically, starting in April, the IRR of all loans originated through our platform is within 24% ahead of the regulatory time line. Regarding credit agency reform, we act proactively and have designed our workable structure with credit agencies. We intend to gradually implement these procedures.

In addition, we have also adjusted product offerings to align with our optimized funding structure, reflecting the asset preference of new national funding sources. This allowed us to improve our loan approval rate. In Q1, we connected with more national joint-stock banks. Meanwhile, given the preference of big banks for higher-quality assets and the increased risk of near prime borrowers in the current macro environment, we restructured our asset distribution engine to optimize the matching between loans and funding institutions. We also introduced a dynamic adjustment mechanism for the returns of financial institutions. The mechanism allows banks to get assigned loans better aligned with their preference while ensuring their expected returns. The loan approval rate of our partner banks rose above 75% in Q1 from roughly 70%, 7-0, last December.

As for our users, our key strategy this year is to improve the quality of user base. So far, we have achieved very noticeable progress. Specifically, we leveraged a combination of newly developed pre-A model, RTA (real-time API) technology, and capacity expansion to effectively optimize the quality of user acquisition. Among the customers that applied credit lines in Q1, 38% received the highest rating from the financial institutions for their low-risk credit profiles. Multiple key indicators of user quality continued to improve, such as the ratio of user with fewer multi-platform credit lines, user with mortgage and car loans, user with stable income and user with tangible assets. The improvement of these indicators showed that we have greatly enhanced the resilience of our business and increased user-lifetime value.

The external environment brought a lot of challenges to our business in Q1. However, our team, once again, met the challenge and delivered solid results. Given the ongoing uncertainty related to the COVID, we will continue to stay vigilant on potential risks and maintain prudent operations in order to accomplish our strategic objectives in this transitional year.

2022 will be a quite challenging year for both our company and the industry. There is pressure from the China-U.S. relations on ADRs, regulatory development for industry and impact from the pandemic. Nonetheless, we believe these factors are gradually turning around especially with the recent positive policy signals. In addition, our consumer loan assets demonstrated very strong resilience during the pandemic.

Looking at our current data compared to the time when the pandemic first hit Wuhan in 2020, we are quite confident from business prospects as the most recent wave of COVID outbreak gradually subsides in China. We expect to see business activities return to normal. The structural upgrades we have made this year to our user base and funding network will put us in a more competitive position. We have seen greater demand for our services, both from end users and from financial institutions and that precisely reflects our growing value.

Going forward, we will invest more in technology to boost our operational efficiency. This will enable us to continually build up our competitive advantages in a markets of great scale and magnitude.

Next, I will turn to our CFO, Alex.

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

Okay. Thank you, Haisheng. Good morning and good evening, everyone, and welcome to our first quarter earnings call. As Haisheng discussed earlier, we had a pretty solid quarter in the rather rough period of time from a macroeconomic perspective.

Consumers' demand for credit came in more or less consistent with normal seasonality in Q1. While we did experience some impacts from the resurgence of COVID in some regions in China, overall asset quality was actually modestly improved during the quarter as optimization of our risk model and the contribution from high-quality new borrowers more than offsetting COVID-related fluctuation among existing borrowers.

Of the 2 leading indicators of the asset quality, overall day 1 delinquency improved to 5.2% from 5.4% Q-on-Q. More importantly, day 1 delinquency for new borrowers in Q1 came in well below 4%, indicating clearly better quality versus existing borrowers. Overall, 30-day collection rate declined modestly to 86% from 87% Q-on-Q, mainly because we had to make necessary adjustments to our collection operation in regions being significantly impacted by COVID.

Again, we see clear deviation between new borrowers and existing borrowers. For new borrowers, 30-day collection rate remained above 90% in Q1. These risk metrics further validate the effectiveness of our user-acquisition strategy, which focused on high-quality segment of the market.

Total net revenue for Q1 was CNY 4.3 billion versus CNY 4.4 billion in Q4 and CNY 3.6 billion a year ago. Revenue from credit-driven service, capital heavy, was CNY 2.9 billion compared to CNY 2.7 billion in Q4 and CNY 2.5 billion a year ago. The year-on-year and sequential increase was mainly due to longer average tenor of the loans, growth in on-balance sheet loans as well as the releasing guarantee liability on previous loan balance, more than offsetting the negative impact from decline in average prices of the loans. Capital heavy facilitation revenue take rate actually improved modestly versus Q4, also due to longer loan tenor.

Revenue from platform service, capital light, was CNY 1.4 billion compared to CNY 1.7 billion in Q4 and CNY 1.1 billion a year ago. The year-on-year growth was mainly driven by a significant increase in capital-light loan balance. The sequential decline was due to a decrease in capital-light loan volume along with the decline in capital-light revenue take rate in Q1.

During the quarter, capital light and other technology solutions contributed roughly 54% of the total loan volume. As we discussed in previous calls, we expect capital light and other tech solutions percentage contribution to our total volume to remain fluctuating around current level throughout this year. Longer term, though, we will continue to pursue tech-driven business model and expect capital light to become a larger portion of our business in the long run.

During the quarter, average prices of our loan portfolio dropped by 50 basis points and were below 24%. In fact, all new cap heavy and cap light loans are already priced below 24% at this point in time. We are very confident to achieve the rate cap requirement ahead of the regulatory deadline. During the quarter, sales and marketing expense declined approximately 12% Q-on-Q, mainly because of the Chinese New Year holiday as well as our prudent control of the pace of our user acquisition.

On a blended basis, average cost per user with approved credit line was CNY 417 compared to CNY 319 in Q4. Again, this blended calculation, evenly spread sales marketing expenses among users with high credit line of between RMB 100,000 to RMB 200,000 as well as those regular users with credit line between RMB 10,000 to RMB 20,000. Logically, unit cost to acquire those high-ticket size users should be just viably much higher than the regular users. Therefore, making comparison of blended user acquisition cost become neither relevant nor reliable.

So on an apple-to-apple basis, excluding large ticket-sized users, average cost per approved credit line of regular users was approximately CNY 322 in Q1 compared to CNY 246 in Q4. More importantly, average cost per dollar amount credit line remained relatively stable Q-on-Q for regular users. 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 the profitability of our operations.

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Although overall risk profile of our loan portfolio modestly improved in Q1 due to the contribution from high-quality new users, the impact from macro uncertainty and COVID resurgence were still noticeable among existing users. Therefore, we continued to take a prudent approach in booking provisions against the potential credit loss. New provision for contingent liability for loans originated in the quarter was approximately CNY 1.4 billion. Meanwhile, approximately CNY 440 million of provisions for contingent liability of previous period loans was written back as actual performance of those loans was better than expected.

With strong operating results and stable contribution from cap-light model, our leverage ratio, which is defined as a risk-bearing loan balance divided by shareholders' equity, was at historically low at 4.2x in Q1 compared to 5.4x 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 generated approximately CNY 1.4 billion cash from operations in Q1 compared to CNY 2 billion in Q4. The decline in operating cash flow was mainly due to some COVID-related timing issue. As Shanghai being locked down late in Q1, we were unable to complete some administrative procedures that normally are required near the end of the quarter to collect receivables from some financial institutional partners. As such, approximately CNY 400 million Q1 receivables are pushed into Q2 to collect, assuming the lockdown in Shanghai gradually easing.

Total cash and cash equivalents was CNY 9.8 billion in Q1 compared to CNY 9.6 billion in Q4. Non-restricted cash was approximately CNY 6.2 billion in Q1 versus CNY 6.1 billion in Q4. As always, a significant portion of our cash would normally be allocated to support the security deposit and other usage in our 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, to satisfy potential regulatory requirements and to return to our shareholders.

In accordance with the dividend policy approved by our Board last year, we declared another dividend of USD 0.22 per ADS for Q1. The cash dividends represent approximately 20% of our Q1 earnings.

Finally, regarding our outlook for 2022. As we communicated to the market previously, we believe 2022 will be a transitional year for the industry as the participants are adjusting to the new regulatory settings. Meanwhile, the unexpected outbreak of COVID as well as associated measures to control the outbreak create additional macro uncertainties. Therefore, we want to maintain a prudent approach to plan our business and mitigate potential risks.

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 the opportunity for us to optimize our operations, strengthen our technology platform and upgrading our customer base to build an even stronger foundation for our future growth. As always, this 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) Our first question is from Yada Li, CICC.

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

(foreign language) Then I'll do the translation part. So the first one is about we have made a capital injection last year for our micro loan license. And could you please elaborate more about how we plan to use it? Is it just a preparation for planning for the national license? Or are we actually starting using it as an alternative funding source maybe in the very near future? And the second one is, considering the resurgence of the COVID-19 and these uncertainties in the economy, there will be some challenges, especially in the loan collection and in off-line business development. So to be more specific, how are we going to deal with the situation?

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

[Interpreted] For two of your questions, for the first one. Yes, you are right for the CNY 5 billion capital that we used to inject into the micro lending license. On the other hand, we also leveraged the capital at the funding resource through the channel of ADS or joint lending products, both of which can improve our leverage ratio. For your second question, first of all, we do not do the post collection through off-line. The pandemic impact us only to the off-line customer acquisition. All of our loan collection process are conducted through online and impact is, in fact, very, very limited from this pandemic. I hope this clarifies all your questions.

Operator

Next question is Thomas Chong, Jefferies.

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

(foreign language) I have a question regarding our business brand on a month-on-month basis starting in April. And how should we think about the low end and the high end of the guidance and our assumption about the recovery trend in the coming quarters? And how should we think about the recovery in terms of the consumer sentiment in coming quarters? My second question is about how are we seeing the business trend in top and lower-tier cities given the pandemic impact more on the Tier 1 cities?

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

(foreign language) Alex?

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

Okay. Thomas, thanks for your question. So from the overall business trend, we look at it, our current assumption is that, as you know, that Shanghai will be gradually sort of reopen starting from maybe June. And so we are assuming a certain level of activity return to Shanghai, maybe starting next month. And we don't expect a sort of a V-shaped turnaround right away. I don't think that's built in our model. We are expecting a rather -- compared to, say, 2020, when Wuhan pandemic happened, it was a V-shaped turnaround. But this time, we are expecting a rather slower, gradual kind of recovery after the COVID. So that's what we are building in our forecast.

In terms of Tier 1 cities, again, the Shanghai situation is well published. And like I said, at least according to the official media, it is gradually reopening, and we expect to get some kind of return of normal operation starting from June. For other cities like Beijing, for one, operational-wise, we probably don't have much large exposure in Beijing. But two, the Beijing situation is slightly different from Shanghai or, I would say, quite different from Shanghai, meaning like a significant portion of the normal life in city is still remaining. And yes, there are certain kind of community lockdowns and so and so. But the situation is much better than it was in Shanghai at the peak of the pandemic last month. And so again, for this kind of situation, we obviously were closely monitoring the development in Beijing. But I don't think it will be anywhere near the Shanghai situation in terms of impact to our business or anything.

Operator

Next question is Alex Ye from UBS.

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

(foreign language) Okay. I will translate for my question. First one is on asset quality. Can you give us some color on your related trend on day 1 and M1 collection rate? Do you expect them to remain stable or some deterioration in Q2? And also just want to clarify that as mentioned, the expected vintage loss will improve from 2.8% to 2.4% to 2.7%. Just wanted to confirm whether that, that refers to the total loan book. And second question is on take rate and APR. So I'm wondering what's your average APR now, and what's the current plan from now to Q2? Do you expect it to further decline? And do you expect your take rate to bottom in Q1 or may continue to edge down? And then for your new users that have a a bit lower risk, I'm assuming they will also have a lower APR, so from a risk-adjusted perspective, how does the return compare to your existing users?

Yan Zheng ***360 DigiTech, Inc. - CRO***

[Interpreted] Okay. Thank you for your question. So regarding to the vintage loss, it indicates the new transactions drawdown in the first quarter. And for the new customers we acquired in the first quarter, actually, the performance will be better than the new transactions in the first quarter, because we have seen the quality of our new customers have been improved. For your first question, the delinquency

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rate also refers to the existing loans on book. And we have seen that it has been decreased in April and May. And if you check the new transactions and it will be decreased to 3%. Regarding to the recovery or collection rate, and apart from regions like Shanghai, Beijing and Henan, for other regions, the recovery rate is better than April. So we foresee that the overall risk performance or recovery rate will be better in the second quarter. Hopefully, this can clarify your question.

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

[Interpreted] Yes, starting in April, the IRR of loan products facilitated and originated to our platform is about 22%. In the near term, we expect this rate to remain relatively stable, and we do not expect to see a big drop on APR rate.

For the new customers we've acquired in the first quarter, if we only look at the short-term return, yes, compared to previous user base is relatively lower. However, we value more on the whole lifetime value that the new group users contribute a lot much better than the previous user group.

Operator

(Operator Instructions) Our next question is Ethan Wang from CLSA.

Yushen Wang ***CLSA Limited, Research Division - Research Analyst***

(foreign language) Just a quick follow-up question on the take rate. Because our take rate, it's also affected by funding costs. Just wondering, in the COVID environment whether the banks (inaudible) can really pass some pressure on this. And do you see reduced funding cost? Just want to see if management can offer more color on there.

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

[Interpreted] Yes, Ethan, to answer your question, first, we do notice we have sufficient funding supply this year. We noticed the funding cost declining trend. We feel that we do not see noticeable decline actually happened. This is because in last year, 2021, we have already brought down a lot of our funding costs. The next point is we focus more on our tech business, for example, capital light, which is less impacted by funding costs.

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

I just want to add a quick point there. So basically, Haisheng means that as we expand into the large national banks, that's actually our focus job for this year. Along the way, there will be modest drop in funding costs, but not as significant as we did in the last year or previous couple of years. Because at 7%, actually, we are already probably one of the best funding costs among our peers.

Operator

And this is the end of the Q&A session. Now I hand back to management for closing remarks.

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

Okay. Thank you again for everyone who joined our conference call. If you have additional questions, please contact us off-line. Thank you.

Operator

This concludes our conference call. You may disconnect now. Goodbye.

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

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