REFINITIV STREETEVENTS

EDITED TRANSCRIPT

Q2 2020 360 Finance Inc Earnings Call

EVENT DATE/TIME: AUGUST 24, 2020 / 12:00PM GMT

CORPORATE PARTICIPANTS

Haisheng Wu *360 Finance, Inc. - President, CEO & Director*
Alex Xu *360 Finance, Inc. - CFO*
Mandy Dong *360 Finance,Inc. - IR Director*

CONFERENCE CALL PARTICIPANTS

Daphne Poon *Citigroup Inc., Research Division - VP & Senior Associate*
Jacky Zuo *China Renaissance Securities (US) Inc., Research Division - Analyst*
Steven Chan *Haitong International Research Limited - Executive Director*
Yushen Wang *CLSA Limited, Research Division - Research Analyst*

PRESENTATION

Operator

Good day, ladies and gentlemen, welcome to the 360 Finance Second Quarter 2020 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 Finance,Inc. - IR Director***

Thank you, Shin. Hello, everyone, and welcome to our second quarter 2020 earnings conference call. Our results were issued earlier today on the IR website. Joining me today are Mr. Wu Haisheng, our CEO and Director; Mr. Alex Xu, our CFO; and Mr. Zheng Yan, our CRO.

Before we begin the prepared remarks, I'd like to remind you of the company's safe harbor statement. Except for historical information, the material discussed here may contain forward-looking statements. These statements are based on our current plans, estimates and projections. Therefore, you should not place undue reliance on them.

Forward-looking statements involve inherent risks and uncertainty. We caution that a number of important factors could cause actual results to differ materially from those contained in forward-looking statements. For more information about potential risks and uncertainty, please refer to the company's filing with the SEC. Also, this call includes discussion of certain non-GAAP measures. Please refer to our earnings release for a reconciliation of the non-GAAP measure to the most directly comparable GAAP ones. But 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 Finance, Inc. - President, CEO & Director***

Thank you, Mandy.

(foreign language)

Alex Xu ***360 Finance, Inc. - CFO***

[Interpreted] Hello, everyone. I'm very proud to report strong financial and operating results for the second quarter. While the macro environment remained challenging, we still set a number of records in key operational metrics. Total loan origination reached CNY 58.9 billion during the quarter, up 21.8% year-on-year. Outstanding loan balance increased to CNY 78.5 billion from CNY 74.1 billion a quarter ago. For the second quarter, total revenue reached CNY 3.34 billion and non-GAAP net income reached CNY 942 million. This is the most outstanding quarterly results since our IPO.

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

(foreign language)

Alex Xu ***360 Finance, Inc. - CFO***

[Interpreted] Our solid performance under the still uncertain micro backdrop further demonstrated the effectiveness of our prudent operational strategy as well as the resilience of our customer base and our risk management system. We believe we have built a structural advantage of our peers, which enable us to successfully navigate through previous market uncertainties, such as the P2P crackdown, the regulatory changes and the pandemic. In each of those cases, we further strengthened our leadership position. With the macro environment economy recovers, we see continued improvement in our operational metrics, and we feel confident in our future prospects.

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

(foreign language)

Alex Xu ***360 Finance, Inc. - CFO***

[Interpreted] Our take rates for the quarter improved noticeably, driven by our continued efforts to boost operational efficiency and to refine our risk management systems, funding structure and customer acquisition channels. Average pricing during the quarter was 27.2% on an IRR basis, which is equivalent of 15% to 16% on an APR basis. Day-1 delinquency decreased to 6.2% at the end of Q2. This was even better than the pre-pandemic level of 6.5%.

Moreover, our funding costs further decreased to 7.2% from 7.7% in the prior quarter, well below the [industry] (corrected by company after the call) average. In the first half of 2020, we issued total 1.1 billion ABSs and ranked #4 behind Ant Financial, JD and Xiaomi in terms of total insurance size. We acquired 1.6 million new customers with approved credit lines in the second quarter, which is 200,000 more than in Q1. And the average acquisition cost for those new customers was about 167, modestly higher than in Q1. As the market gradually consolidate towards leading platforms, we have increasingly become a preferred fintech partner for many consumer-focused Internet companies. So far, we have connected our service with 11 partners, including Xiaomi, Meituan, iQIYI and many others, including JD, Didi, 58.com and Weibo are in the pipeline.

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

(foreign language)

Alex Xu ***360 Finance, Inc. - CFO***

[Interpreted] Our new product initiatives also tracked very well in Q2. Daily transaction volume of our virtual credit card products V-pocket reached RMB 50 million at the end of the second quarter, connecting 2.5 million accumulated users with about 2 million merchants and processing 450,000 daily transactions. Intelligent Credit Engine, which connects institutions with our vast inactive user base added another RMB 20 million daily transaction volume to our platform. We expect the momentum to continue and greatly enhance the stickiness and activity level of our user base.

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

(foreign language)

Alex Xu ***360 Finance, Inc. - CFO***

[Interpreted] We made further progress in strategically upgrading to a technology powered digital platform. During the quarter, capital-light model and other tech powered solutions accounted for over 26.9% of total loan origination, and we remain committed to increase the capital-light contribution to 35% to 40% exiting this year. In addition to capital-light model, we're also working on standardizing our risk management capabilities into SaaS modules and offer them to financial institutions. As of now, 6 institutions have already used this service and 20 more is in the pipeline. In the long run, we will continue to invest more in our fintech capabilities and further strengthen our competitive edges. By our calculation, tech-enabled revenues and platform services revenues are already nearly 50% of our total revenue. Recently, we have proposed to our Board of Directors and shareholders to change our name to 360 DigiTech, which will better reflect our current business dynamics and long-term strategies.

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

(foreign language)

Alex Xu ***360 Finance, Inc. - CFO***

[Interpreted] Last week, the Supreme People's Court of PRC announced a new guideline to reduce court protected interest rate cap for private lending. We have anticipated and prepared for this prior to the release. Shortly after the official announcement of the guideline, we held a conference call to communicate our point of view with the capital market. While it is generally believed that the new guidelines are only applicable to private lending, we are prepared for the possibility that the financial regulator may refer to this guideline as well. In addition, it is widely believed that the 15.4% interest rate cap referred to -- referred in the guideline is the nominal APR based, which is equivalent to roughly 27.3% on an IRR basis. This is more or less in line with our current average pricing. As a result, we expect this impact to our operations to be manageable. Recently, we tested some experimental pricing structure with certain group of users, essentially offering loans to them at lower rates than they otherwise would get. The result indicates that a carefully managed pricing discount could potentially lead to a higher customer LTV to the company, as users may become more active and sticky. In the intermediate term, we believe that the regulators will likely encourage a gradual downward trend in the interest rate and it is consistent with our long-term strategy of serving a much broader user base at a relatively lower price.

In early May, our affiliated company 360 Group has committed significant resources in becoming the controlling shareholder of a national bank, KCB. This will provide strong and vital support for us to further reduce funding costs, diversify product offerings and strategically upgrade to a technology powered digital platform.

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

(foreign language)

Alex Xu ***360 Finance, Inc. - CFO***

[Interpreted] Finally, let me introduce our newly appointed CFO, Mr. Alex Xu. He was the CFO of Qihoo 360, when it was listed in the U.S. Many of you may have already known him. Our former CFO, Jiang Wu, has been appointed as our CSO. I would like to thank Jiang Wu for his great efforts in building up a prudent internal financial system and presenting our company in the capital market well.

Now I will pass the floor to Alex Xu to dive into the details of financial performance.

Alex Xu ***360 Finance, Inc. - CFO***

Thank you, Haisheng. Good evening, and good morning, everyone. Welcome to our quarterly earnings call. For the interest of time, I will not go over all the financial line items on the call. Please refer to our earnings release for those details. Q2 marked a sharp rebound for our business momentum from Q1. As the concerns over COVID-19 gradually faded, the country entered recovery mode and economic activities gradually picked up during the quarter. Benefiting from such micro trend, we have experienced robust rebound in our operations, particularly in the second half of the quarter. Total net revenues for Q2 reached CNY 3.34 billion versus CNY 3.18 billion in Q1 and CNY 2.23 billion a year ago. The year-over-year comparison is somewhat distorted by the accounting standard change early this year. Total operating expenses, excluding the provisions, increased 12% Q-on-Q, but decreased 27% year-on-year. The sequential increase was in part driven by our deployment of resources to support business growth in the quarter. In particular, we further strengthened our collection operations and on the ground customer acquisition teams. The year-over-year decline reflected significant improvement in customer acquisition costs.

Non-GAAP net income was CNY 942 million versus CNY 255 million in Q1 and CNY 692 million a year ago.

Once again, the year-over-year comparison was impacted by the accounting standard change. On an apple-to-apple comparison basis, under the old accounting standard, non-GAAP net income would have been approximately CNY 1.3 billion, representing an approximately 87% year-over-year increase. With a growing contribution from capital-light model and a sizable increase in shareholders' equity, leverage ratio declined meaningfully to 8.3x in Q2 compared to 9.5x in Q1. Again, leverage ratios were also impacted by accounting standard change.

Under the old standard leverage ratio in Q2 would have been 6.3x versus 9.8x a year ago. While leverage ratio may vary from quarter-to-quarter, we expect to see overall downward trend going forward as capital-light model continues to grow, and we continue to create shareholders' equity.

Meanwhile, our provision coverage ratio remained at a healthy 3.2x in Q2 compared to 4.0x in Q1. The sequential decrease in provision coverage ratio was mainly because loans originated in previous quarters performed better than expected and the provisions for those loans were lowered by approximately 300 million in Q2. For risk-bearing loans originated in Q2, we took similar conservative approach to Q1 to estimate potential losses and provisions for contingent liability.

Free cash reached a record high of CNY 1.8 billion in Q2. This was largely driven by strong operating results and effective management of working capital. Total cash and cash equivalents were CNY 7.4 billion at the end of Q2. Majority of our cash was allocated to security deposits with our financial institutional partners and also the registered capital of different entities to support our daily operation. We also leave a sizable buffer for any market uncertainties in the cash reserve. We believe that such a sufficient cash position will not only enable us to compete in the ever-changing market but also position us to capture potential growth opportunity in the market recovery.

Finally, let me give you some color about our outlook for the third quarter and the full year. The strong positive momentum we experienced in the second half of Q2 has continued into current quarter, both in demand and asset quality. However, with the global pandemic still lingering and the impact of the recent regulatory change still somewhat unclear, we will continue to take a prudent and conservative approach in our business planning. Therefore, we would like to maintain our full year loan origination guidance of RMB 200 billion to RMB 220 billion. With that, I would like to conclude our prepared remarks. Operator, we can now take some questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) We have the question from Ms. Daphne Poon from Citi.

Daphne Poon ***Citigroup Inc., Research Division - VP & Senior Associate***

(foreign language)

So I will translate the question. So mainly 2 questions. The first question is regarding your loan pricing. Just want to get a sense from the management how -- given the latest regulation coming out from the Supreme Court, how fast and how much you expect your APR to come down, say, in the coming few quarters or next 1 to 2 years' time? And also whether you have done any stress test about what your breakeven interest rate would be? And the second question is for the Intelligent Credit Engine that you mentioned earlier. You mentioned it's for activating some of your existing users. So can you elaborate more in terms of the product features, such as long-term pricing, ticket size, et cetera? And how is that different from your current capital-light model?

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

(foreign language)

Alex Xu ***360 Finance, Inc. - CFO***

[Interpreted] Okay. In terms of the trend of interest rate or the pricing, actually, quite a while ago, we already determined that the overall interest rate trend will gradually trend down, both from our understanding with the regulatory environment and also from actually internal assessment. We believe that with a gradually lowered interest rate or pricing we can reach a broader base, a much broader user base and to basically increase the overall size of the business in the long run.

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

(foreign language)

Alex Xu ***360 Finance, Inc. - CFO***

[Interpreted] And also we look at our current structure in terms of take rate, I think we have pretty reasonably good take rate of our current operation, which means that there's plenty of room to maneuver in the new interest environment. And also, our overall operational efficiency, probably among the best among our peers. And that, again, give us the room to kind of profit or getting growth in the new interest environment. And then with the KCB joined as our partner, we have a further advantage in terms of low cost funding and that also will help us deal with a relatively lower pricing environment.

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

(foreign language)

Alex Xu ***360 Finance, Inc. - CFO***

[Interpreted] Yes. And in terms of a breakeven point to your second part of the first question, obviously, it's a little bit too early to do the detailed calculation. But roughly speaking, it's just a back of the envelope kind of calculation. Right now we look at it, it's about 16% on the IRR basis. Somewhere around that number is our breakeven point based on current model. That point, by the way, we haven't really considered any sort of incremental volume that associated with the lower rate environment.

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

(foreign language)

Alex Xu ***360 Finance, Inc. - CFO***

[Interpreted] Okay. In terms of Intelligent Credit Engine, really, the purpose for that is to activate our, you can call it, sleepy users. As you know, we have nearly 30 million users with the approved credit lines. But on any given quarter or any given time, the ones that actually use the credit lines, it's only less than 10 million. So there's close to 20 million users, we can call it inactive users. For those users, we link them with the financial institutions. The product itself will be based on the bank's brand as opposed to the 360 brand. And also, we use the differentiated pricing to attract those users. So for many users, they may have a better kind of impression to the bank's brand in this case. That's how we can activate those users from a sleepy kind of stage.

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

(foreign language)

Alex Xu ***360 Finance, Inc. - CFO***

[Interpreted] Okay. And the difference between this Intelligent Credit Engine and the capital-light model is that under the Intelligent Credit Engine, like I said earlier, the brand is under the bank's brand, not our brand. And also, in this model, we don't do after-loan management. The bank will do that after-loan management there, whereas in the capital-light model, we do the after-lending management work. But we do help the bank to do the customer acquisition and also some prescreens in terms of risk management prior to the lending activity. So the pricing or the take rate of the Intelligent Credit Engine and cap-light. The intelligent Credit Engine side is slightly lower than the cap-light model, but not too much difference there. Yes, that's it.

Daphne Poon ***Citigroup Inc., Research Division - VP & Senior Associate***

(foreign language) So just a follow-up question regarding the longer-term take rate and the outlook. At what level do you think it will decline to or you feel more comfortable in the long term?

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

(foreign language)

Alex Xu ***360 Finance, Inc. - CFO***

[Interpreted] So we really don't set a target for the take rate in our daily operation. Really, what we look at this dynamic is that in the so-called new interest environment, we want to serve a broader user base. As the environment drives the overall take rate probably for the entire industry gradually lower, then we just follow that that trend. So we don't foresee or we don't expect the take rate to see dramatic decline in any short period of time. It's more like a gradual with the overall industry environment kind of scenario there.

Operator

(Operator Instructions) Next we will have Mr. Jacky Zuo from China Renaissance to ask your question.

Jacky Zuo ***China Renaissance Securities (US) Inc., Research Division - Analyst***

(foreign language) So I will translate. So congrats on the results. So my main question is about the asset quality. So just want to ask what is the trend in July and August regarding the day 1 delinquency rate, 30 days collection rates. And what is our estimate for the vintage loss ratio of the new loans issued in the first half? And lastly, what is the day 7 delinquency rate, if we can disclose that?

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

(foreign language)

Alex Xu ***360 Finance, Inc. - CFO***

[Interpreted] Okay. Jackie, the overall improvement of asset quality continued into current quarter. And Mr. Zheng basically mentioned that the -- exiting the second quarter, our day 1 delinquency was about 6.2%. And now if you look at the current number, it's already -- for a few weeks, it's already consistently below 6 in terms of day 1 delinquency. And then for the 30-day collection rates, actually, in the second quarter, we were at about 88%. Right now, this number is already between 89% and 90%. So we continue on a very positive trend line there.

In terms of the expected vintage loss for the current portfolio, the range we gave was between 2.5% to 3.5%. Right now this number or I would say in the second quarter this number is sitting about 3%, given the delinquency leading indicator trend. When we look at it it's possible down the road, the actual vintage loss probably will be lower than that number.

In terms of the FPD 7, the delinquency there, pre pandemic, we were running at about 0.9% to 1%. And at the peak of the pandemic, we were hit like 1.84%. Now this number is already coming back to significantly lower. Right now, we're running about 0.8% for that metric.

Jacky Zuo ***China Renaissance Securities (US) Inc., Research Division - Analyst***

(foreign language) So a simple follow-up on this. I observed that given the improved asset quality, we should have the provision write-back in the second quarter. So what is the number and do we expect further write-back in the third quarter?

Alex Xu ***360 Finance, Inc. - CFO***

Sure, Jackie. I will take this part of the question. If you look at the financial statement, for the first quarter, we booked a CNY 1.7 billion provision for contingent liability. Of that CNY 1.7 billion, CNY 1.4 billion is for the loans issued in the Q1. And then CNY 300 million was for the loan issued prior to Q1. And then in the second quarter, the total provision for contingent liability was about CNY 1 billion. Within that CNY 1 billion, the provision for the loan issued in Q2 was actually CNY 1.3 -- I believe, CNY 1.32 billion. But at the same time, because the loans we issued in previous quarter actually performed better than we initially thought, so there will be a write-back about CNY 300 million in Q2 for those provision numbers there. That gives you the net provision for contingent liability for Q2 at about CNY 1 billion.

Jacky Zuo ***China Renaissance Securities (US) Inc., Research Division - Analyst***

Okay, so do we expect further write back in the third quarter?

Alex Xu ***360 Finance, Inc. - CFO***

Sorry. If you look at the way we took the provisions there, for the first and second quarter for the new loans, we took pretty much similar number of -- amount of provision, one is CNY 1.4 billion, the second quarter it's CNY 1.3 billion. So both are, I would say, very conservative approach to estimate the provision there. If the trend we're looking today continues, meaning the asset quality continues to improve, you should probably continue to expect to see this write-back on the provisions in the coming quarters.

Operator

Now I would like to call upon Mr. Steven Chan from Haitong International.

Steven Chan ***Haitong International Research Limited - Executive Director***

(foreign language)

So I'll translate. After the change of the name from 360 Finance to 360 DigiTech, I just want to understand whether there will be any change in the business strategy, especially, are we going to change from a fintech company to a TechFin company, especially we're going to introduce -- we have introduced this Intelligent Credit Engine, which is very similar to capital-light model. And if we're really going to change from a FinTech company to a TechFin company, which bigger payers should we compare us with? Should we compare with OneConnect or Jingdong?

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

(foreign language)

Alex Xu ***360 Finance, Inc. - CFO***

Okay. Steve, thanks for the question. So yes, we propose to change our name from 360 Finance to 360 DigiTech. Because if you look at the history of the company, the founding team of the company, as you know, is coming from 360 Group, which by itself is more a tech-based team. And our resources, at least in initial funding, the resources and the capabilities are all coming from the technology side. We just apply those resource and technologies to the financial service industry there.

In the short term, we still have a lot of things we can do for the financial service segment of the market. And for example, the customers we're serving today are more or less focused on the mid- to higher end in terms of interest range. Down the road, we are looking for a much broader user base to cover the lower end or mid- to -lower end, the interest rate. In particular, with the help of the KCB, that will enable us to reach that goal. So eventually, you will find ourselves build a whether you call it a TechFin or FinTech platform. It's a very unique one compared to most of others because we become probably one of the only who can serve a broader, I would say, full range of the interest range of a customer base down the road.

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

(foreign language)

Alex Xu ***360 Finance, Inc. - CFO***

[Interpreted] Sure. And then also, Steven, from the institutional side, as you know, right now, we already have a relationship with over 100 financial institutions. Many of those institutions have different sort of service scenarios that we can work on and in the future develop more like a standardized product, to achieve our tech enabling capability there. And in the long run, we can help those institutions from both technology and risk management and customer acquisition fronts to serve them to become really a major tech platform for those players. From that perspective, we probably, to your question, looks a little bit similar to OneConnect there. But at the same time, we also have this loan facilitation business and also the lending business. That to some degree, has made us look like a combination of Ant Financial's Jiebei plus OneConnect. And further beyond that, as you know, one of our affiliates gets the insurance broker license that can in the future become part of our listing company's portfolio. So we can expand that business beyond the current lending plus tech service, adding additional elements in there.

Operator

In the absence of time, we would like to have the next last question from Mr. Ethan Wang from CLSA.

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

(foreign language) My question is on customer acquisition channel. Just wondering what is the split of the customer acquisition channel now compared to pre pandemic? And I hope management can share some more data on the credit product, so we can understand more about its growth.

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

(foreign language)

Alex Xu ***360 Finance, Inc. - CFO***

[Interpreted] Okay. In terms of the customer acquisition, given the current market uncertainty, still lingering uncertainty in the market, our customer acquisition strategy is more focused on the existing old users, you can call that, as opposed to the new users. That basically gives us the pretty good handle in terms of control of the customer acquisition cost. In addition to focus on the existing users, we also take some approach in technology as well as in the format we acquire users to control the customer acquisition costs. For example, we have the partnership with the ones we mentioned like Xiaomi, Meituan, those kind of Internet platform that will connect to our service and we get a certain type of a revenue-sharing model with them to do the customer acquisition. That also helps us to enhance our overall user acquisition cost there. And given our current focus on the existing users, meaning there's still quite a bit of room for us to acquire new users down the road when we feel the overall market condition is right. And we will basically adjust our strategy with the time.

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

(foreign language)

Alex Xu ***360 Finance, Inc. - CFO***

[Interpreted] So I want to spend some time emphasizing on this new customer acquisition strategy in terms of partnership with the so-called Internet platforms out there. In the past, they have many partners they can choose from, meaning the other fintech platforms. But as the time goes, they realize, both from the asset quality as well as the customer service perspective, in particular, the customer complaints ratio and all these metrics, we are way ahead of our peers. So we essentially become the default or the best partner for those Internet platforms there. That's why since recently, we start to accelerate connecting our service with these Internet partners. As we mentioned in the prepared remarks, we had connect 11 in total already. And then there's still quite a bit of numbers out there in the pipeline. Right now, the total customer acquisition from this kind of partnership already accounts for about 20% of our total new customer acquisition.

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

(foreign language)

Alex Xu ***360 Finance, Inc. - CFO***

[Interpreted] And also, secondly, I want to also refer to our relationship or our potential partnership with the bank, with KCB because relatively speaking, the banks have better branding or brand recognition or brand quality as well as low-cost capital there. So by partner with KCB, we can design a lot of different kinds of low-priced products offered to our customers. And also with the bank joined our efforts, we can connect this kind of platform with more scenario-based situations there and eventually cover a much broader user base in terms of the different interest range or different pricing range. That's, again, back to our goal. Eventually, we want to serve a much broader, I would say, full range interest range customer base from low to high down the road.

Operator

Thank you very much. So ladies and gentlemen, this concludes today's conference call. Thank you for your participation. You may now disconnect. Thank you very much.

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