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Q4 2021 360 DigiTech Inc Earnings Call

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## PRESENTATION

**Mandy Dong** 360 DigiTech, Inc. - IR Director

Thank you. Hello, everyone, and welcome to our Fourth Quarter and Full Year 2021 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 would 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 statement 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 here are in RMB.

I will now turn the call over to our CEO, Mr. Wu Haisheng.

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

[Interpreted]

Hello, everyone. I'm very happy to report another solid quarter that capped off a strong year. In 2021, total loan facilitation through our platform reached RMB 357.1 billion, up 45% year-on-year. This beats the midpoint of our raised full-year guidance. In Q4, total loan facilitation reached RMB 96.9 billion, up 40% year-on-year. Outstanding loan balance reached RMB 142 billion, up 54% year-on-year. Our business overcame multiple challenges related to macro economy uncertainty, sporadic outbreak of COVID and the fast-changing regulatory environment in a rather volatile year of 2021. We managed to deliver the growth while maintaining stable asset quality and further demonstrating the resilience and the flexibility of our business.

Now, let me walk you through some updates for Q4.

Regulation remains an area that draws a lot of attention. So let me first share some updates here. The overarching theme of the government policy for 2022 is very clear, which is to achieve steady economic growth by driving consumption, suggesting more supportive to the development of consumer finance. We expect the policymakers to introduce additional measures to drive consumption and support SMEs as China's State Council has made the above-mentioned policy theme as their higher priority. For example, in its municipal level 14th Five Year Plan for the financial industry reform, City of Chongqing supports the expansion of consumer finance industry through a proper loosening of financing restrictions for consumer finance companies. At the central government level, the PBOC has acknowledged the value of fintech in its Fintech Development Plan for 2022 to 2025. There are tremendous opportunities for financial institutions and the tech companies to work together and contribute to the digital transformation of financial sector. In addition, the PBOC and other national regulators are promoting innovation in financial standardization outlined in the 14th Five Year Plan for Financial Standardization. We actively participate in policy design-related discussion organized by regulators and contribute our industry know-how to support the efforts.

In Q4, we started to implement rectification measures in accordance with the regulatory requirements. We have enhanced our corporate governance structure and further focused on our core business. At a recent briefing, Guo Shuqing, Chairman of CBIRC stated that the self-check part of rectification work has been largely completed. Overall progress of rectification has been smooth so far and are confident to complete the rectification work very well. Based on the regulatory guidelines and our own business needs, we increased the registered capital of our micro-lending subsidiary in Fuzhou to RMB 5 billion. This enhanced our capabilities to serve users and manage risks. Going forward, we will continue our strategies on both direct and indirect loan services. On one hand, we will offer loans through our micro-lending company directly to target customers and industries. On the other hand, we will work with credit agencies and help financial institutions better serve consumers. We believe that financial regulators will continue to work on the implementation of the previously released general regulatory principles, such as financial services can only be undertaken with proper financial licenses. They will focus on the execution of the rectification plan and regular monitoring of the progress. We are entering the late-stage of many rectification process and waiting for the review and the certification by the regulators.

In Q4, we also made progress in a few other compliance-related areas, average APR for loans facilitated through our platform declined 2% from previous quarter, effectively brought down the cost for our borrowers. In terms of user data-related compliance, we continue to increase investment in data security and data protection. The China Cybersecurity Review Technology and Certification Center, CCRC, awarded its security certification to our flagship product, the 360 Jietiao APP, adding another national certification for privacy protection to our products. We also obtained the ISO 27701 certification, Privacy Protection Management System issued by SGS, a well-known international standard certification organization. This is the second important international standard certification in privacy and information protection area we received, following the ISO 27701 Information Security Management System a few months ago. In addition, the Cybersecurity Management Bureau under the Ministry of Industry and Information Technology, MIIT, issued a written commendation acknowledging our excellent performance in the special campaign for app users' privacy protection.

In Q4, we also achieved excellent results in several operational areas.

On the product front, our consumer loan business achieved high-quality growth throughout the year. Our SME loan products, which we launched last year, grew rapidly and delivered satisfactory results. In Q4, total amount of new approved credit lines for SME loans accelerated and grew by, 1-6, 16% sequentially to RMB 9.3 billion. As of the end of 2021, the outstanding loan balance of SME loans accounted for, 1-3, 13% of our total loan book. Meanwhile, we continue to refine SME products and expand to better quality customer group by offering larger ticket size products, targeting specific SME groups off-line. For example, we expanded our collaboration with banks to access corporate credit records. This allows us to offer bigger ticket size credit products and attract more high-quality SME borrowers. Another effective approach is that, we offer customized products to the tobacco and alcohol retail borrowers during Chinese New Year when their funding needs surge and turnover increases. To capitalize such opportunities, we simplified approval procedures and increased direct sales for these customer groups. In December, credit lines granted to the tobacco retail borrowers acquired by our direct sales team accounted for more than 20% of the total SMEs and the transaction volume increased by, 1-0-6, 106% on a monthly basis. Meanwhile, starting off this year to offer differentiated services to SMEs and consumers and to improve efficiency, we will serve SME users through an upgraded app separate from 360 Jietiao. In addition, on top of the credit services we currently provide, we will actively explore other service and products to better support SMEs business operations.

In collaboration with financial institutions, we leveraged our technology advantage and expanded partnership with stronger financial institutions. This enabled us to further optimize the mix of our financial institution partners and establish a more balanced and resilient partner network. Newly added financial institution partners have broad regional coverage, strong risk management capability and diverse business lines. Moreover, our ICE product offers competitive edge to better fit in the compliance requirement of some banks. This will enable us to develop standard solutions to work with more banks in the future. Meanwhile, we continued ABS insurance in Q4 with a total of RMB 1.1 billion at a low coupon rate of 5.7%. This brought our total ABS insurance for the full-year to RMB 6.5 billion, up by 282% year-on-year. Our overall ABS funding cost for 2021 was 5.47%.

As for our customer base, the overall quality of newly acquired customers gradually improved coming along with lower pricing. The value of those high-quality customers will be gradually released over the life cycle. As price declines, we note some key indicators of user quality improved significantly, such as the ratio of user with multi-platform credit lines, user with mortgage and car loans, user with a

stable income and users with tangible assets. Based on the A/B group test we conducted, the drawdown ratio and retention rate are both higher for borrowers at lower pricing. We expect these customers will generate higher LTV as well.

In Q4, we also made noticeable progress to enhance our tech capabilities on multiple fronts as we remain committed to become a tech-empowered loan facilitating platforms, serving our financial institution partners and borrowers. We leverage our AI and big data tech to effectively identify customer risk profiles and then match borrowing needs and funding resources based massive data inputs.

First, we made major upgrades to the framework of our smart marketing system. This significantly improved our ability to better identify users and enlarge our processing capacity. Our average user quality was up by over 20%. Our efficiency in user acquisition was also improved by over 20%. The scale of our identifiable user base increased by threefold.

Second, we continued to make key innovations by deepening integration of AI application with our Argus Risk Management System, in the areas of community detection, hierarchical federated learning and risk management strategy automation. These have strengthened our ability to identify potential borrowers and manage risk.

Third, as for AI-powered operational technology, our proprietary production diagnosis platform provides one-stop smart diagnostic services, which embed expert experience into automated tools. These tools ensure the stability and accessibility of our services. The platform can identify problems within 30 seconds and boost our diagnostic efficiency by 90%.

Looking ahead of 2022, considering the macro uncertainties, we will continue to take prudent operating strategy as always. From what we have learned from past success, we believe that holding prudent and steady approach in day-to-day operation is the golden standard for the fintech business when macro uncertainties arise.

After all the rectification in 2021, we expect to see a much clearer regulatory framework for the fintech industry in 2022, which should allow industry participants to be more focused on long-term business development. We will prioritize our technology-driven strategy and continue to invest in R&D, further pursuing innovative solutions and business models. For our 2B business, we will explore more diverse products and services for different financial institutions. Meanwhile, we will collaborate with stronger financial institutions to optimize the mix and the quality of our partnership network and ultimately to boost our services sustainability.

For 2C business, we will continue to upgrade our technology and models to better identify high-quality borrowers and optimize our user base matrix. We will roll out more products catering to these high-quality customers. This will bring higher customer LTV and retention rates as well. We are seeing very positive changes in our business following all the hard work we did last year. Thus, we are quite looking forward to the year ahead.

For our on-balance sheet loan business, we have increased the registered capital of our licensed micro-lending subsidiary to RMB 5 billion. This is a crucial strategy resource that we definitely will capitalize on.

With these structural upgrades and improvements, I believe we will serve our customers, partners and society more efficiently in 2022, making us a healthier and more resilient and more sustainable company. This will enable us to better serve the real economy and contribute to China's overall strategy for steady economy growth.

Now, I will turn to our CFO, Alex for more financial details.

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

Thank you, Haisheng. Good morning and good evening, everyone. Welcome to our quarterly earnings call. As Haisheng mentioned, despite facing multiple macro challenges, we delivered solid Q4 results in both operations and financial fronts, and finished 2021 with a series of record-setting annual numbers on the book. During the quarter, we saw continued healthy consumer demand for credit, while asset quality was fluctuating in Q4 mainly as a result of seasonal tightening of money supply in the financial system, we are glad to see improvement in the new year as funding becomes ample.

Net revenue for Q4 was CNY4.4 billion versus CNY4.6 billion in Q3 and CNY3.3 billion a year ago. Revenue from credit-driven service (capital-heavy) was CNY2.71 billion compared to CNY2.62 billion in Q3 and CNY2.56 billion a year ago. The year-on-year and sequential increase was mainly due to growth in on-balance sheet loans and releasing guarantee liability on previous loan balance, more than offsetting the decline in capital-heavy facilitation volume and revenue take rate. The take rate decline was as expected, as the average prices of our loans were lowered by 200 basis point during the quarter, while the offsetting factors yet to kick in. Revenue from platform service capital-light was CNY1.71 billion, compared to CNY1.99 billion in Q3 and CNY780 million a year ago. The strong year-over-year growth was mainly driven by a significant increase in capital-light loan volume. The sequential decline was due to a decrease in capital-light loan volume, along with a modest decline in revenue take rate in Q4.

During the quarter, capital-light and other technology solution contributed roughly 54% of total loan volume. Capital-light loan volume was negatively impacted by seasonal shortage of overall funding supply, as well as the 24% rate cap related tightening from traditional funding sources. At least for the first half of 2022, we expect capital-light percentage contribution to our total volume to remain fluctuating around current level as the industry gradually adjusts to the new rate cap. At the core of our long-term growth strategy, we will continue to pursue tech-driven business model. After this transitional period in 2022, we expect capital-light to become a larger portion of our business in the long run.

During the quarter, average pricing of our loan portfolio dropped by 200 basis points. And by the end of 2021, average interest rate of loans on our platform were already below 24%. The 200 basis point cut in Q4 was faster than previous trajectory and we did it proactively. We believe this will give us a great flexibility in Q1 and Q2 of 2022 to be in compliance with the regulatory requirements and ultimately hit our rate cut target by mid-year deadline.

During the quarter, on a blended basis, average customer acquisition cost per user with approved credit line was CNY319 compared to CNY305 in Q3. As we elaborated in last quarter's earnings call, we continued to focus on attracting high-quality borrowers, those with much larger credit lines and relatively low risks. The average ticket size of these customers typically run between 150,000 to 200,000 compared to average of 10,000 for our regular borrowers. The unit cost to acquire those high-quality customers are justifiably much higher than the regular borrowers. So to compare things apple-to-apple, excluding large ticket size customers in both consumer and SME markets, average cost per approved credit line of regular borrowers was approximately CNY246 in Q4 compared to CNY249 in Q3. As we discussed in the past, average cost per approved credit line is a calculated number with limited value in our internal decision-making process. We will continue to use lifecycle ROI and LTV as key metrics to determine the pace and scope of our customer acquisition strategy. Throughout 2021, we have maintained healthy ROI and our LTV trend, which in turn drives stable net take rates.

As overall risk metrics fluctuating in Q4, we continued to take prudent approach in booking provisions against potential credit loss. New provision for contingent liability for loans originated in the quarter was approximately CNY1.6 billion. Meanwhile, approximately CNY400 million of provision for contingent liability of previous period loans was written back as actual performance of those loans was better than expected.

Effective tax rate for Q4 was approximately 14.8%, which brought full-year ETR to approximately 17.3%. Going forward, we expect ETR to normalize to around 15%, which will be sustainable in the foreseeable future based on our current tax planning schedule.

With strong operating results and stable contribution from capital-light model, our leverage ratio, which is defined as a risk-bearing loan balance divided by shareholders' equity remain at a historical low of 4.3x in Q4 compared to 6.6x a year ago. We expect to see rather stable leverage ratios for the time being until capital-light contribution resumes growth in the future.

We generated CNY2 billion cash from operations in Q4, compared to CNY1.8 billion in Q3 and CNY1.2 billion a year ago. Total cash and cash equivalent was CNY9.6 billion in Q4, compared to CNY7.6 billion in Q3. Non-restricted cash was approximately CNY6.1 billion in Q4 versus CNY4.2 billion in Q3. The meaningful increase in cash was in part due to the timing of the registered capital increase for our micro-lending subsidiary, which results in large cash balance sitting in bank accounts at the year-end as opposed to being deployed in normal course of the business. As always, a significant portion of our cash would normally be allocated to support our on-balance sheet loans and security deposit with our institutional partners. As we'll continue to generate healthy cash flow from operations, we believe our current tax position is sufficient to support the growth of our business to invest in key technologies, to satisfy the potential regulatory

requirements and to return to our shareholders. If you recall, our Board of Directors approved a quarterly dividend policy in Q3, allowing us to distribute approximately 15% to 20% of quarterly net income after tax in the form of cash dividends on a recurring basis. In accordance with this dividend policy, we declared another quarterly dividend of USD0.26 per ADS for Q4. This cash dividend represents approximately 20% of our Q4 earnings.

Finally, let me give you some update about 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, as well as some macro uncertainties. As such, we expect total loan volume for the year to be between RMB 410 billion and RMB 450 billion, representing year-on-year growth of 15% to [25%] (corrected by company after the call). We view this transitional year as an opportunity for us to optimize our operation, strengthen our technology platform and upgrading our customer base, to build an even stronger foundation for future growth. As always, this forecast reflects the company's current and preliminary views, which is subject to material change.

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

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## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions) Our first question is Yada Li from CICC.

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

(foreign language) Okay. Now I will do the translation. The first one is, I'd like to know the progress of the pricing adjustments. What's the proportion of loans in 4Q '21 that are priced under the 24%? And how much this proportion can reach up to for the first quarter this year? And when the pricing going downward and the target customers sort of get strong, I was wondering how are we shifting our customer acquisition strategy.

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

Sure. I would take the first part of the question and then Haisheng will do the second part. So in the fourth quarter, over 70% of our customers are priced below 24%. And as I mentioned in the prepared remarks, by year ending, the average price is already below 24%. And this quarter, in Q1, we're expecting even larger portion of customers being priced below 24%. And we are pretty confident that we will get the targeted rate cut goal by the mid-year deadline. Haisheng?

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

[Interpreted] Yes. Let me translate for our CEO. As for your question, the customer acquisition strategy to access the higher quality customer groups, we will leverage 3 approaches. Number one, further invest more in R&D to improve our tech and the AI models to better identify the customer risk profiles. We already see dramatic improvement in Q4. Second approach, we adjust our API customer acquisition approach with our platform partners. Thirdly, we deployed an off-line team, which historically showed is a much better approach, especially for the high-quality customers.

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### Operator

Our next question is Yixi Xu from Morgan Stanley.

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### Richard Xu *Morgan Stanley - Analyst*

(foreign language) Basically, my question is on the funding front. There has been increase in ABS. Also the small loan company capital injection is also completed. So want to see whether there is a credit line with the banks where cooperation with the banks is still expanding. And what will be the long-term mix in terms of the funding between capital-light, capital-heavy and then their different funding sources? (foreign language)

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

[Interpreted] Yes, to answer your question, Richard, you are very correct. First, we will continuously expand our number of financial institution partners by introducing stronger banks. As this comes along, we can offer larger ticket size to better quality customers.

Second, as for the capital-light volume, we will explore more diverse products catering to different needs of financial institutions. Their needs include marketing service, risk management service and loan collection service.

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

I just want to add one point. So from a longer-term perspective, the capital-light contribution, as I mentioned in the prepared remarks, will be moving higher from current level. If you recall, in the past, we were at some point targeting like 2/3 or 70%. I think from a longer-term perspective, that's probably still be the target. This year, we'll be fluctuated around this current level just because the whole industry is adjusting to the new environment. And when we're done with this adjustment, the trendline will start to move to the higher direction for capital-light.

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**Operator**

Our next question is Ethan Wang, CLSA.

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

(foreign language) Okay. I have 2 questions. Firstly, a quick follow-up. Just wondering the funding cost for the fourth quarter and the management view on funding cost for this year.

And second question is on the market concern on tightening regulation for the local financial institutions or quasi financial institutions. And so, for the regional banks who we are collaborating, just wondering whether they are having concern on this front, and whether that's going to impact our business. And for the guarantee companies, does that mean they will set up various institutions across the country, so we can cooperate with them to lend nationwide?

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

Okay. I will take the first part again and then Haisheng will be taking care of the second one. So for the funding costs for the Q4, it was approximately 7%. And the Q4, as you know, it's always been a very tightening period from money supply perspective in the financial system. So normally that's reflecting the funding costs. And for moving into this year, as we sort of gradually transition to new institutional partners, the overall funding supply will get more sufficient. But during this transitional period, we are expecting a rather stable funding cost around 7%. And after we've done with this transitional, we'll probably start to see a gradual, although modest kind of decline in funding cost in the long run. Haisheng?

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

[Interpreted] Yes, Ethan, to answer your question, number one, your question comes from the very early requirement that the online loan business for urban commercial banks, this is quite early regulation and the regulator gives a rather long grace period for all the market participants. The cutoff date issue is January 1 this year. Currently, all our financial institution partners are within the compliance. Secondly, looking at the metrics of our financial institution partners network, most of them are national wide operations. Therefore, we have very limited impact from this regulation.

Yes. As for the second part of your question, the regional restriction for guarantee companies, guarantee company can set local branch national wide to satisfy these requirements. It's comparatively easy compared to the banks to cover national wide.

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**Operator**

Our next question is Thomas Chong from Jefferies.

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

(foreign language) I have 2 questions. My first question is about the SME strategies. Can management comments about how we should think about the contribution over the future, as well as the borrowing cost and the loan size going forward, together with the industry categories that we are working with?

And my second question is more about the macro headwinds that we are facing these days, and outbreak of COVID. Are we seeing any changes in terms of the consumer behavior in terms of the use of the proceeds?

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

[Interpreted] Well, first, regarding your question about SME business, the average ticket size for SME products overall is about RMB 50,000. For some tax loans, which is larger ticket size, usually we provide products over RMB 250,000. For the tax loan, we estimate the marketing expense is around 2%.

Secondly, for your question about the use of loan. As most of our consumers were in the industry that are less impacted around the COVID and the macro economy, we are seeing their use of loan is consistent with previous.

I want to add more color for our operating strategy for SME business line. Even under the tremendous demand from SME borrowers and the supportive policy from government, we take a very prudent strategy in this business. We focus on those industries that are less impacted by the macro economy, such as manufacturing and retail. This year, we do not expect to accelerate exponentially in these business line. Again, we will take a very conservative role. Also, we like to explore more capital-light and more tech-driven solutions for financial institutions in this SME business.

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**Operator**

Thank you. This is the end of our question-and-answer sections. Now, I give it back to the management for closing remark. Thank you.

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

Okay. Thank you again, for participating in the call. And if you have any additional questions, please contact us off-line and we'll discuss then. Thank you.

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**Operator**

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

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

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