X Financial (XYF)
Fourth Quarter 2018 Earnings Conference Call
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Executives:
Justin Tang, Founder, Chief Executive Officer and Chairman
Kevin Zhang, Chief Financial Officer
Simon Cheng, President
Jennifer Zhang, Investor Relations

Analysts:
John Cai, Morgan Stanley
Jacky Zuo, Deutsche Bank

Presentation

Operator:

Good morning, and welcome to the X Financial Fourth Quarter 2018 Earnings Conference Call. All participants will be in listen-only mode. After today's presentation, there will be an opportunity to ask questions. Please note this event is being recorded.

I would now like to turn the conference over to Jennifer Zhang. Please go ahead, Investor Relations for X Financial.

Jennifer Zhang: Thank you, operator. Hello, everyone, and thank you for joining us today. The Company's results were released earlier today and are available on the Company's IR website at ir.xiaoyinggroup.com.

On the call today from X Financial are Mr. Justin Tang, Founder, Chairman and CEO; Mr. Simon Cheng, President; and Mr. Kevin Zhang, Chief Financial Officer. Mr. Tang and Mr. Cheng and also Kevin will give a brief overview of the Company's business operations and highlights and also financials and guidance. They are all available to answer your questions during the Q&A session.

I remind you that this call may contain forward-looking statements under the Safe Harbor provisions of the Private Securities Litigation Reform Act of 1995. Such statements are based on management's current expectations and current market and operating conditions, and relate to events that involve known or unknown risks, uncertainties and other risk and other factors, all of which are difficult to predict, and many of which are beyond the Company's control, which may cause the Company's results, performance or achievements to differ materially from those in the forward-looking statements.

Further information regarding these and other risks, uncertainties and factors is included in the Company's filings with the U.S. Securities and Exchange Commission. The Company does not undertake any obligation to update any forward-looking statement as a result of new information, future events, or otherwise, except as required under law.

It is now my pleasure to introduce Mr. Justin Tang. Mr. Tang, please go ahead.

Justin Tang （Chairman & CEO）: Hello, everyone. We are pleased to report our financial and operating results for 2018. Despite a volatile market environment, we facilitated RMB 36,913 million in loans in 2018, generated RMB 3.5 billion in revenue and RMB 1.05 billion in non-GAAP profit, representing an increase of 98% and 155% respectively from the prior year.

Since the second half of 2018, the industry has been under strict government oversight, with many small and illegal lending platforms gradually being weeded out of the market. We are confident that a well-regulated industry will provide significant future growth opportunities and generate a strong borrower demand for our personal finance products.

We strongly support the government's new regulations, and believe they will help us to improve our overall risk controls and management capabilities, enhance industrial reputation, reduce over-leverage by the borrowers, and provide the best-in-class personal financing solutions.

Since the outlook of registration of P2P lenders remains unclear, over the past few months, we have been diversifying our funding sources and strengthening our cooperation with financial institutions. We started new cooperation with CITIC Trust, the largest trust company in China; Kunlun Bank and the China Foreign Economy and Trade Trust, just for a couple of examples, as well as the major funding intermediaries such as JD Finance, Baidu Finance and Ping An Technology. We are also in discussions with other nationally renowned financial institutions and trusts.

Given that the majority of our products are covered by ZhongAn Insurance, financial institutions have been eager to cooperate with us. At this moment, we have significantly more institutional funding demand than we could provide. Look ahead to 2019, we expect to have a significant portion of our new funding coming from institutional source.

On the operating side, we made several big improvements over the past few months. First of all, we launched our new revolving credit product, Xiaoying Wallet, after significant investing in R&D and testing. Revolving product is much more complicated than simple loan product. We believe this product demonstrates our leading technology capability and swift strategic execution, and it should have enormous growth potential to better meet the needs of our customers.

We have around 50,000 active cardholders now. Our goal in 2019 is to reach 1 million active users for our revolving product.

We will continue to leverage our technology expertise and understanding of financial products to improve our business performance and achieve sustainable and healthy development.

Second, we were pleased to engage CITIC AIBank as our custodian bank to independently manage all borrowers and investor funds. It took us 3 months to complete the switch from the Huarui Bank to CITIC AIBank. We were able to finish this with minimal service interruption. This demonstrates our strong technology and financial execution capabilities.

AIBank is a highly respected institution that has developed the cutting-edge technology and algorithms that will further strengthen trust and security in our online lending platform, improve our overall competitiveness, and ensure we are compliant with the new regulations.

Third, we are one of the few P2P platforms to begin sharing credit information with Baihang Credit, which will integrate, save and process data collected from us and multiple other partner companies. Together with our upgraded version of social network data, this will strengthen our credit assessment system, and allow us to quickly and accurately assess the creditworthiness of borrowers, target a broader user base for financial services, and reduce the cost of risk management.

Overall, we were pleased with the significant progress we have made, and strongly believe that we are ideally positioned to continue benefiting from the enormous growth opportunity in China’s personal finance industry.

We will continue to invest in our technology to strengthen our risk management capability, and develop partnerships with corporate and institutional investors to further diversify our funding sources and generate long-term sustainable growth.

Lastly, I am pleased to announce that the Board of Directors has declared a cash dividend of US$0.10 per ADS for full year 2018 as part of our new annual dividend policy. We believe the dividend scheme will demonstrate the strong growth potential of our business and future business prospects and the Company's strong desire to reward our shareholders.

With that, I will turn the call over to Simon who will further discuss our business prospects.

Simon Cheng (President): Thank you, Justin. Hello, everyone. We continue to deliver solid growth during difficult macro-economic environment while maintaining healthy credit quality in 2018 Q4. We have also made investment in our risk management infrastructure and customer acquisition and service capabilities during past quarter, which will benefit our future growth.

Adopting fintech technologies to promote micro SME lending and consumer lending is clearly stated by the Chinese regulator, and X Financial’s capability to generate high-quality asset from online micro lending is well recognized and welcomed in retail investment community through P2P and institutional investors across China. X Financial is well positioned to work with our partners in this growing area in 2019 as a leading fintech player in China.

I will turn the call to Kevin, who will go through our financials.

Kevin Zhang (CFO): Thank you, Simon. Hello, everybody. We delivered solid results during the fourth quarter and the whole year of 2018. We are happy to see our business begin to recover starting in the fourth quarter following the lows of the third quarter of 2018.

The total loan facilitation amount in the fourth quarter of 2018 was RMB 9.5 billion, exceeding our previously announced guidance of RMB 8 billion to RMB 8.5 billion, an increase of 25% for loan facilitated in Q3, which demonstrates strong market demand and our industry-leading position.

Our average APR for the whole year of 2018 was about 25%.

For time consideration, I will not go over every line item of our financials. For a more detailed discussion, please refer to our earnings press release.

Net revenue for the full year of 2018 increased by 98% to RMB 3.5 billion from RMB 1.8 billion in 2017, driven by our focus on the core product, Xiaoying Card Loans, whose volume more than doubled of that in 2017.

Our operating efficiency is increasing Q4 2018. Operating costs and expenses, which are comprised of origination and service costs, G&A costs and sales and marketing expenses as a percentage of loan volume facilitated in Q4 is 4.7% compared with the 5.3% in Q3.

The group effective tax rate for the full year of 2018 is 19.3% compared to 28.9% in 2017. Most subsidiaries of the group are now enjoying the 15% favorable income tax rate as being recognized a tech company.

Our non-GAAP net income was RMB 280 million and RMB 1.05 billion in the fourth quarter of 2018 and the full year of 2018, respectively.

Net income per ADS for the full year 2018 was RMB 5.82 on a full year diluted basis. The non-GAAP fully diluted net income per ADS were RMB 6.94.

Besides, X Financial currently expects that the total loan facilitation for the first quarter of 2019 to be approximately RMB 9 billion.

This forecast reflects the Company's current and preliminary views, which are subject to change.

Now, this concludes our remarks, and we'd like to open the call to questions. Operator, please.

Questions and Answers

Operator: We will now begin the question-and-answer session. (Operator Instructions). John Cai, Morgan Stanley.

John Cai: I have three questions. The first one is on your product mix. I think the portion of card loan has declined in the fourth quarter. And also I think the ticket size of the overall loan facilitation has also declined. So just wonder what's driving that. Is there any product mix change? And if there's any, what's the rationale behind this change?

The second question is on the balance sheet, actually I think particularly on the financial guarantee derivative. I think in the third quarter, it is in liability, but in the fourth quarter it seems we have turned this into an asset. And the amount is notable at more than RMB 350 million. So just wonder what's driving that change, and also a few other P&L -- I'm sorry -- balance sheet items such as the short-term borrowing, why we need to do some short-term borrowing, given the cash we have on hand. So that's the second one on the balance sheet side.

The final question is on the customer acquisition. So just wonder what's our acquisition cost for the fourth quarter, what's the current trend? And also, this 315 CCTV gala on last Friday that seems to have some impact on this loan supermarket. I'm not sure whether that would impact our customer acquisition activities.

Justin Tang: Thanks, John; this is Justin. I will answer your first and third questions. I will have Kevin answer your second question.

For the first question, the average loan size actually decreased during Q4, and the reason we reduced our average ticket size is really based on our data-driven risk management capability. During last year, because the economy situation in China became more challenging, as well as the credit situation became more contracted. So the delinquency situation obviously worsened for the whole industry.

As a result, starting fromQ3, we're starting to reduce average loan size to our creditors, and this is to improve our loan performance, which actually already turned out positive results as we see right now. We see the new loan we started to give out since Q4, starting to show positive performance than the loan we extended through most of 2018.

In terms of our credit card balance transfer loan accounts for a smaller percentage of our business in Q4. The key reason is actually, the whole P2P industry experienced a funding crunch during Q3. But then in Q4, the leading platform like us rebounded very strongly, swe have more than sufficient investor demand for our product. As a result in Q4, we started to direct more of our business to provide the funding to other major fintech platforms.

So other major fintech platforms start to refer their borrowers to us, so companies such as Loans 360, for example, those kinds of major platforms, they refer their borrowers to us; that accounts for a bigger portion of our business. And that's the key driver for our credit card loan account for a smaller portion of our business.

Your third question is our customer acquisition costs, which remain very manageable. You look at it on both sides. On the investor side we started to see customer acquisition cost going even lower. And one of the reasons is China now have regulation to require the P2P platform to maintain their balance at a certain amount. So at this moment, we have much significantly more investor funding demand than we could provide it.

So as a result, in February, we reduced the interest rate we provide to our investors. For example, the 1-year product, we reduced interest from 8% to 7.2%, that reflects a strong investor demand for our product which we could not satisfy.

On the borrower side, our customer acquisition cost remains stable. I actually believe we are benefiting from 315, this consumer day, because there are loan supermarkets which used to provide traffic to irregular lenders. Now, the irregular lenders actually has been kicked out of the market.

So those traffic platforms are more inclined to provide traffic to more compliant companies, such as us. So I think actually, it will work towards our favor. So I think going forward for 2019, we believe the customer acquisition cost for our existing business will be very manageable.

In 2019, we're going to make investment is our revolving credit business. We believe this is long-term a fundamentally important business for us. There are several hundred millions of people in China who could not get a credit card, and if we could be one of the first players to provide them with a mobile revolving credit line, this is a fundamentally important product.

So we will invest pretty aggressively for customer acquisition for our revolving product. Like I said in the call, we target to reach like a million active users by the end of 2019.

So that's the answer for your first and third question. I will turn to Kevin for your second financial-related question.

Kevin Zhang: Thank you, Justin. Hi, John. I will answer your question two

Actually, the short-term borrowing is actually related to what we call 外保内贷. It's kind of how we use our proceeds we raised in our IPO and take back in China. That means we will get our US dollar time deposit pledged overseas, and ask local bank to get some short-term borrowings. Thanks.

And that's why you also see on our balance sheet, we have restricted cash. Actually, we have pledged our U.S. dollar account deposit for around RMB 400 million. And in December 2018, we got RMB 200 million borrowings from local bank, we get another RMB 200 million short term borrowings. That's what the impact of 外保内贷.

With regard to the increase of financial derivatives, guaranteed derivatives, it's a little complicated.

Actually, when we're talking about what we attract from our borrowers, there are some portions. The first portion will be the interest, and then there will be the insurance fee paid to ZhongAn. And we also got some guarantee fee collected borrowers, but which will be compensated to ZhongAn with a certain cap, as a kind of reimbursement for ZhongAn's compensation to the investors.

And you may notice that the delinquency rate for the loan facilitated in June, July of 2018 actually increased a lot also in Q4. And that's resulting increasing compensation for ZhongAn, and we need to reimburse ZhongAn under that cap. But when we talk about our guarantee fee, it will be collected on a monthly basis in the following 12 months.

So actually, after the first several months, we would compensate ZhongAn more than we collect from the borrowers, but so that's why we have a debt balance on our balance sheet. And the balance will decrease in the next few months, there will be less compensation to ZhongAn, and we will get more guarantee fee from the borrowers.

Hope this will resolve your questions.

John Cai: Yes. Thank you, Justin, and thank you, Kevin. So just one quick follow-up on the product mix. So I think we do more internet channels, as I mentioned -- as I recall, that means we facilitate loans for the borrowers from the other platforms. I think that has like a lower take rate than our card loan products, so I think these products lead to decline in take rate. Obviously, that's what we can see.

I think the revenue over the loan facilitation, the first quarter declined on a quarter-on-quarter basis. Just wonder if that's the pure reason, or there's any other reason that's driving the sequential decline of take rate?

Kevin Zhang: Okay. I will try to explain the question. Justin and Simon, you can add more points.

Actually, the decrease of the take rate is partially due to the product mix change. And also we do increase a little bit of the insurance fee and the guarantee fee portion in the Q4 from the borrowers, and the APR remains equal. So actually, the total service fee rate will decrease a little bit for our card loans.

Simon Cheng: Yes, I think we saw delinquency increase from Q3, then particularly for our preferred loan, and that's also part of our product mix. For that part, we need to increase our insurance fee, guarantee fee to cover the loss. This is also a products mix driven change, because SME sector was hard last year, so we slowed down the preferred loan business, now the preferred loan left is very small.

John Cai: Okay. Thank you very much.

Operator: (Operator Instructions). Jacky Zuo, Deutsche Bank.

Jacky Zuo: I have three questions. First one, just want to follow-up on the product mix. Just wondering if you can give us the percentage number of the loan volume from loan facilitation service to other platforms, and also the preferred loans? That would be very helpful.

And the second question is, what is the active borrower number? Just wondering if you can provide that number. Just want to compare with the previous quarter to see the borrower number growth.

And lastly, on the funding mix, can you give us an update on the funding percentage from P2P and institutions for the fourth quarter? And given we have origination volume guidance of 9 billion for the first quarter this year, what will be the funding mix for that, and maybe funding mix overall for 2019?

Justin Tang: Yes, Kevin, could you address these three questions?

Kevin Zhang: Yes. First, when we're talking about the product mix in Q4, the card loan representing about 68% of the total loan volumes. And our loans provided for other fintech companies is about 32 - 33% of the total loan volumes.

Simon Cheng: Loans for other fin-tech platforms was about 18% and for the preferred loans was about 12%. So really talk about close to 70% of card loans and about 18% are for the other platforms and 12% are from preferred loans.

Kevin Zhang: In forward-looking, we believe the card loans will still comprise about 75% to 80% of the total loan volume, and our funding to the other fintech companies which will be about 15% to 20% of the total loan volume in 2019.

Simon Cheng: Okay. And the preferred will become less and less.

Jacky Zuo: Thank you.

Justin Tang: (repeat analyst question) How many active borrowers we have in Q4, and compared to the last quarter?

Simon Cheng: Let's answer the third question about funding first, OK?

Jacky Zuo: Yes, sure, no problem.

Kevin Zhang: In 2018 about 80% or 85% were from the funding for our P2P platforms, and 15% was from those financial institutions and other companies. And when we go to 2019, we expect that about 40% of the total funding will be from the financial institutions for the full year of 2019.

Jacky Zuo: Kevin, just a follow-up, for the fourth quarter, what's the percentage from institutions for the funding?

Kevin Zhang: 15%.

Jacky Zuo: 15%, right, thank you.

Justin Tang: And we have enough pipe line institutional funding. The reason we have only 15% in the fourth quarter is because we want to make sure our retail investors are getting enough investment. So and after December, we have a cap on the P2P outstanding, and then we will switch our funding to institutional funding. And around the year, we probably will have 50% of funding from institutional funding, and we are capable to do more than that, because we have enough pipeline there.

I think, Jacky, you're asking a question about the borrowers. Actually, we don't have that on hand, but I can say absolutely in Q4, we have more borrowers in Q3 and I'll give you two reasons. One is we lowered the ticket size for card loan. So it means with the same volume, we will have more borrowers. And the volume actually increase in Q4 comparing to Q3.

And secondly, our lending through other platforms, actually, their part actually increased in Q4. Actually, they also had a lower ticket size, means that we have more borrowers there. I think we can provide the data later to you, but absolutely, we do see more borrowers in Q4 than Q3.

Jacky Zuo: No problem. Thanks so much. Just a follow-up on the ticket size. Wondering if you can provide the ticket size number for card loans and the loan for card loan. And then what's the trend in Q1 this year and going forward?

Simon Cheng: In the first half of the year for 2018, our card loan ticket size is around 16,000. It's pretty high in the industry for online and in P2P online lending. And starting from June, we saw that the economy was deteriorating and these P2P platform issues, and we lowered the ticket size gradually to about 12,000.

And then we, during the same time on the second half of 2018, we did a lot of reinvestment on our infrastructure, including we built a more complicated model. We have more data, third-party data, from outside, and so our model actually becomes better and better.

So as for Q1, actually we started to increase our ticket size. The reason is actually, our approval rate has been decreasing since the middle of last year. It's the same kind of tightening pressures we had. So we decreased our approval rate; we decreased our ticket size. This is what happened the second half of 2018 to be prudent. So we are very cautious in this difficult environment.

And during the same time, our risk capability has strengthened. We have better model, we have better data. So our approval rate is still very low. We have a lower approval rate today, we believe our model is better. And then actually, for the remaining customers we approved, we started to increase our ticket size.

We believe actually, because we have a better model, and then what we approve today is much better quality than what we approved before. So these people deserve better ticket size. So that also help us in the market to attract better customers because we offer highest credit line in the online lending community and we are able to have better customers.

Jacky Zuo: Yes, that's very helpful. So for the rest of this year, do you expect the ticket size will recover to the same level of first half last year?

Simon Cheng: Yes. Absolutely. Actually, as we tighten our credit policy, we improve our risk management capabilities. Actually, we saw our delinquency rate decrease since January this year. After Chinese New Year actually, the accounts which go to collection actually decreased a lot, much more than we anticipated.

And we have prepared much more because we had prepared a much worsening economic environment, but it turns out it was much better. And so at this moment, I think we can pick up better customers with our ticket size will recover and even higher than what we were in the first half of 2018.

Jacky Zuo: That's helpful. Thanks so much.

Operator: John Cai, Morgan Stanley.

John Cai: To follow up on the institutional funding pipeline, is there anymore color we can get, because if I look at the first quarter guidance, it's 9 billion and it's roughly at a similar level as compared to the fourth quarter. In fourth quarter, we did like more than 9 billion facilitation, yet the balance is largely flat. So if there's anything more detail on the institutional funding.

And the second one is actually relevant question to the institutional funding because we mentioned that our products are covered by ZhongAn Insurance, so I think that would be attractive to institutions. So just wondering if there's any change on our cooperation with ZhongAn Insurance.

And the final question is on the dividend. So it's great to see that we pay out dividends. Just wonder what's the plan on that, like annual dividends or quarterly?

Justin Tang: Yes, John, first question for institutional funding, for Q1, we forecast we do about 9 billion in total loan facilitation. It's in a similar amount to Q4 2018, but you will see institutional funding will account for a bigger percentage of the funding mix than Q4 last year. So as a result, what you're going to see is actually, the loan balance in our P2P platform will actually go down a little bit, and the institutional funding side will increase.

So basically, that is generally in line with company's direction which want to be more balanced funding mix, have more borrower funding come from institutions; and also, to reflect there are just so many demand that come from institution where we have to kind of tighten up or sacrifice our retail investors' allocation a little bit to satisfy institutions' funding appetite.

Second, ZhongAn, our cooperation with ZhongAn has no change, and we remain closely cooperating. Although we have been intentionally to increase our non-ZhongAn insured product more. Again, when we started this business, people very much relied upon ZhongAn to purchase our products, but now there are more and more investors that trust our brand and our products. So they want to buy our products directly without ZhongAn's insurance to get a little bit better yield.

And also it will reduce our potential concentration of ZhongAn because at the end of the day, our business still will consume ZhongAn's capital. We don't want too much rely upon ZhongAn's capital.

For 2019, the insurance premium that ZhongAn charge us will increase a little bit from 2018. Again, on an apple-to-apple basis, you assume the delinquency rate remain the same, the apples-to-apples insurance premium they charge us will increase a little bit, but very much at a manageable level. It's a single-digit increase in their premium basically..

Third, in terms of dividend, it is an annual dividend policy. Obviously, our business continues to generate cash, and we expect to maintain the dividend policy for the foreseeable future.

John Cai: Thank you very much. That's very clear.

Kevin Zhang: Jacky, we got the number of the borrowers in Q3 and Q4. In Q3, we have active borrowers of 641,000 and in Q4, we had about 863,000. That means about 30% increase for the number of borrowers.

Justin Tang: Kevin, that is the new borrowers number.

Kevin Zhang: Yes, new borrowers.

Operator: This concludes our question-and-answer session. I would like to turn the conference back over to Jennifer Zhang for any closing remarks.

Jennifer Zhang: Okay. Thank you, everyone, for joining us on the call today. If you haven't got a chance to raise your questions, we will be pleased to answer them through follow-up contacts. We look forward to speaking with you again in the near future. Thank you.

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