X Financial (XYF)
Third Quarter 2019 Earnings Conference Call
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Executives:
Jennifer Zhang; Investor Relations
Simon Cheng; President
Kevin Zhang; Chief Financial Officer

Analysts:
John Cai; Morgan Stanley
Unidentified Participant; Private Investor

Presentation

Operator: Hello, and welcome to the X Financial third quarter 2019 earnings conference call. All participants will be in listen-only mode. (Operator Instructions) After today's presentation, there will be an opportunity to ask questions. (Operator Instructions) Please note, this event is being recorded.

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

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. Simon Cheng, President; and Mr. Kevin Zhang, Chief Financial Officer. Mr. Cheng will give a brief overview of the company's business operations and highlights, followed by Mr. Zhang, who will go through the 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 factors, all of which are difficult to predict, and many of which are beyond the company's control, which may cause the company's actual 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 statements as a result of new information, future events or otherwise, except as required under law.

It is now my pleasure to introduce Mr. Simon Cheng. Mr. Cheng, please go ahead.

Simon Cheng: Hello, everyone. We are pleased to report a good quarter with strong financial and operational performance. In particular, I would like to highlight the following significant progress we have made across our business.

Firstly, we believe that controlling the credit risk at origination is critical. Over the past six months, we have tightened our credit policies and shifted our customer segment to a higher-quality segment to prepare for difficult regulation wave and economic environment. Delinquencies of our portfolio have decreased. This helps us to achieve a more stable business and reduced loan defaults in the longer time.

Secondly, we are very pleased to report that institutional funding accounted for 35.7% of the loans facilitated through our platform in the third quarter, increasing from 26.7% in the previous quarter. Particularly, the proportion of funding from institutions increased to 52.4% of the total loans facilitated in October 2019.

We expect institutional investors to fund almost all our new loan originations from the beginning of next year as our P2P platform are to be gradually phased out. We have been actively negotiating with our funding partners, including CITIC Trust, Kunlun Bank, Blue Ocean Bank, Huishang Bank, Yantai Bank and others, to further lower our funding costs and provide the best service to our customer.

Lastly, it is very encouraging to see our revolving loan product Yaoqianhua, previously known as Xiaoying Wallet, growing very rapidly. Transaction volumes for Yaoqianhua jumped significantly to RMB1.4 billion this quarter from RMB971 million last quarter and the outstanding loan balance increased to RMB949 million as of September 30, 2019, from RMB578 million as of June 30, 2019.

The number of transactions for Yaoqianhua in the third quarter of 2019 increased to 3.8 million, from 2.9 million in the second quarter. The number of active users of Yaoqianhua was around 330,000, representing an increase from 220,000 as of June 30, 2019. It's a 50% increase. We believe that the number of Yaoqianhua users will keep rapid growing. The business will gradually account for a larger percentage of revenue, as revolving product has a longer customer life time and offers multiple types of cross-sell opportunities.

Furthermore, for the users of Yaoqianhua, we are able to offer more diversified services to enhance the user experience. We are planning to gradually transit from a pure financial service provider to a comprehensive service provider.

Overall, as our customer segments will be shifted to higher-quality customers, more and more of our income will come from comprehensive service fees, such as merchant fees, managing fees, et cetera, in addition to loan facilitation fees. At the same time, there will be lower delinquencies down the road and lower funding costs.

In conclusion, we are very confident in our future growth prospects and our capability to create long-term value for our investors and shareholders. Since the industry is in consolidation, there will be fewer players to continuously provide the user friendly and convenient personal financial services to the borrowers in China. China's consumer finance market is huge and growing. Interest rates and funding costs are in a declining trend. We believe there is enormous potential for our business growth after this consolidation period.

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

Kevin Zhang: Thank you, Simon. We finished the quarter with solid operational and financial results. Total loan facilitation amount was about RMB10.7 billion for the quarter, showing a significant increase year-over-year, while net revenue came in at RMB867 million, which also increased on a year-over-year basis.

We are glad to see the number of active borrowers increase significantly to 840,000 in this quarter, which demonstrates continued strong demand from the market.

The delinquency rates for all outstanding loans that are past due for 31-90 days and 91–180 days as of September 30, 2019, were 2.95% and 4.50%, respectively, compared with 3.10% and 4.99%, respectively, as of June 30, 2019. We believe this reflects the improving quality of our loans. We will continue to strengthen our risk control capability and provide the best loan service to our customers.

In addition, we are pleased to see the proportion of institutional funding and revenue contribution from the loan assistance business model continuing to grow. As of September 30, 2019, the credit line provided by our institutional partners was around RMB38 billion and has expanded to RMB48 billion by the end of October 2019. We are determined to operate in compliance with related laws and regulations, and are actively making a transition to a mode of combination of loan assistance and direct loan in the short-term license.

What's more, the loan products we facilitated that were covered by ZhongAn Insurance have decreased to 77% in the third quarter 2019. We will continue to reduce our insurance coverage rate to lower our customers' borrowing costs and develop alternative ways to provide guarantees for certain loan products.

Going into next year, we will continue the transformation of our business to ensure it is fully compliant with regulations, reduce costs and improve efficiency, and create more value for our customers and shareholders.

Now I'd like to brief some financial performance. Net revenues in the third quarter of 2019 increased by 4.5% to RMB867 million, from RMB829 million in the same period of 2018, primarily due to an increase in transaction volumes of Xiaoying Credit Loan and Yaoqianhua this quarter when compared with the same period of 2018.

Origination and servicing expenses in the third quarter of 2019 increased to RMB456 million, from RMB284 million in the same period of 2018, primarily due to the following factors (i) an increase in collection expenses for the cumulative effect of the growing business; (ii), continuous investments in customer acquisitions, especially for the recently launched revolving credit product, Yaoqianhua.

The sales and marketing expense in the third quarter of 2019 decreased by 43% to RMB26 million, from RMB45 million in the same period of 2018, primarily due to a reduction in promotional and advertisement expenses, since we are ramping up funding for our P2P model.

The non-GAAP net income in the third quarter of 2019 decreased to RMB170 million, which is mainly resulting from our continuous investments in customer acquisitions. We believe such revolving investment will benefit us in the long run, both for high-quality customers and the longer user life cycle.

Now I'll turn to guidance. We expect the total loan facilitation for the fourth quarter of 2019 to be around RMB8 billion to RMB9 billion. This forecast reflects the company's current and preliminary views, which are subject to changes.

Now this concludes our prepared 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. I guess the first one is about our risk performance. I think our reported delinquency rate declined on a sequential basis due to the tightening of the credit policy previously, so how do we think of the current factor risks? Meaning that do you see it's a time that, because we have already controlled the previous existing rates, it's a time for us to take more risk now? How is the risk environment that management is seeing? So any assessments on the current risk environment, and how does that impact our growth? That's the first one.

The second one is we'd like to know more about our product segment. So we see that you provided more details about the term loans and the revolving loans this quarter, so we just wonder if management can share about the economics of the term loan versus the revolving loan. And I think it should be a positive change on the take rate for this quarter, so if management can comment about the take rate changes that they would be helpful as well.

The third question is a bit technical. On the revenue side, I see that the loan facilitation income from the intermediary model picked up for these two quarters. I'm not sure why is that, because my understanding is that most of the facilitation fee should be under the direct model. Yes, those are my questions. Thank you very much!

Simon Cheng: Thank you, John. This is Simon. I'll answer the first question regarding the credit quality, and Kevin can answer the last two regarding the financials. We have tightened our credit policies, and more importantly, actually, we shifted our customer segment to a high-quality segment. So down the road, we will see our delinquencies keep going down, and this is one of the segment changes in addition to our prudent credit control policies.

The financials, Kevin can answer.

Kevin Zhang: Hi, John. Thank you for your questions. First, about our product mix for the segment, I will say that at this moment, the term loan is our dominant key product and which will contribute more than 95% of the total revenue and our profit. And you may see when we are talking about the loan volume, as of the third quarter, there were about 1.4 billion of the transaction volume that came from Yaoqianhua, the revolving credit product. That's about 10% of the total transaction volume. But at this time, we are still investing in these revolving credit loans, so actually the revenue contribution and the profit contribution for our recycled products will still be very limited.

And when we're talking about the take rate, the general take rate for our term loan will be very similar to the total take rate. That means it's around 10%. And for Yaoqianhua, the recycled product, it has a take rate of about 13%. This is for our term loans. And actually, our take rate remained stable in the last quarter, and we see that our total pricing remained unchanged, and our funding costs and our delinquency rates are relatively stable. So the take rate will be very similar to that in Q2.

But I would like to draw your attention that, as previously mentioned by Simon, we are targeting for high-quality customers, and we are also changing our pricing mechanism. But instead of the pure finance servicing income, we are now receiving a comprehensive sales income by directing our user base into our membership systems from November, so a series of package of rights, which are composed of both redemption rights and financial rights, will be sold to our members.

So later on, our revenue will be actually split into two parts. One is from our loan facilitation revenues, and then the remaining one is some of our comprehensive service income directly charged to our customers. And as these comprehensive incomes are not bound with the loans, so there will be a little change in the future. So at that moment, we will have a different view about how our take rate changes. That means in Q4, the take rate will be lower, but we will have some additional comprehensive service income.

I hope that this can answer your questions. And your third question, when you're talking about the revenue from the intermediary rate model, actually, in Q2 and Q3, when we had the loan under the low occupancy models, actually, some of our funding partners, we would first issue the loans via our partner micro-loan companies and then transfer to those institutional funding partners. So under this model, we will have more intermediary-level revenue, so that's why our revenue at the intermediary level increased in Q2 and Q3.

John Cai: So if I may follow up on the risk, I just want to get a sense of management's assessment of the current environment, because we have heard that some players are seeing a rise in risk, and it's also this regulatory tightening on collection, data analytics, et cetera. So what is management's assessment on the current risk level on the sector as a whole? So do you see that it's more risky now as compared to maybe a quarter ago? And how do the regulations impact the overall collection efforts, recovery rates, delinquency rates? Yes, just any color on that from management would be very helpful.

Simon Cheng: Thank you, John. Actually, it's a very tough regulatory environment right now. There were a lot of changes recently. Overall, we believe that will actually lead to industry consolidation and some players will leave the industry and there's a new environment. But for us, actually, we are prepared for this, and as I said earlier, we are shifting our customer segment to a high-quality segment, which means we will have less issues with recent regulatory developments. And also, this better quality segment is more resilient to the economic change, so this is our strategy.

And overall, we believe for certain segments there might be a deterioration situation, but for the segment we are talking right now, actually, it's still quite healthy, and for employment, the situation in China is quite stable, and for the customer finance business, for the higher-quality segment, it's actually still quite stable.

Operator: (Operator Instructions) The next question comes from Luvian Han, a private investor.

Luvian Han: My question is about the credit risk. We can see the risk items in the P&L, like provisions for accounts receivable and contracts and fair value items, like fair value adjustment related to financial guarantee derivatives and fair value adjustments related to consolidated checks. We can see these items increased compared with Q2, but you mentioned that the delinquency ratio was improved compared with Q2. So which side showed the real credit risk?

Kevin Zhang: Thank you for your question. Actually, in general, our credit performance is stable or, as we mentioned, has improved. But when we go through the P&L, for example, you see some indicators there might be confusing. For example, the provision for accounts receivable increased in Q3 when compared to Q2. Actually, that was more from accounting, and that means as of Q1, our credit performance has improved, but at that time, we were not sure whether this would be sustainable, so actually we cannot do a timely adjustment for those credit adjustments. So all of the impacts were actually just in Q2, while we are more sure that our credit controls are actually enhanced.

So if we can combine those items for the first half-year, you will see that it was very similar to those for Q3. I can give you some color on impact of the accounting when we do some period-end adjustments.

Luvian Han: So you mean the items in the P&L showed the future risks. Yes?

Kevin Zhang: Are you comparing those with our performance in the same period in 2018, or those for Q2 of 2019? I'm not sure which items you are comparing it with.

Luvian Han: Compared with 2019 Q2.

Kevin Zhang: Oh, 2019. Yes, as I already mentioned, for example, generally our credit risks are improved as stable, at the end of Q1, we actually saw there were improvements. But we could not do those adjustments on our P&L because we were not sure whether this improvement would be sustainable, so then we are more prudent. And at the end of Q2, we saw several clear trends that our credit performances were more stable and were improving, so actually all those impacts were definitely in Q2. So that means you see some very small amounts for those accounts receivable provisions in Q2. But if you compare the amount of customer receivable provisions in Q3 with the average amount of Q1 and Q2, the average amount of the first half will be very similar.

Operator: (Operator Instructions) 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: Thank you, everyone, for joining us on the call today. If you haven't gotten 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: The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.