X Financial [XYF]
Third-Quarter 2018 Earnings Conference Call
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Company Representatives:
Jennifer Zhang; IRD
Justin Tang; Founder, Chairman and Chief Executive Officer
Kevin Zhang; Chief Financial Officer
Simon Cheng; President

Analysts:
Jackie Zuo; Deutsche Bank
John Cai; Morgan Stanley
Michelle Li; AMTD Group

Presentation:

Operator: Good day, and welcome to the X Financial third-quarter 2018 earnings conference call. (Operator Instructions) Please note this event is being recorded.

I would now like to turn the conference over to Jennifer Zhang. 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. Justin Tang, Founder, Chairman and CEO; Mr. Simon Cheng, President; and Mr. Kevin Zhang, Chief Financial Officer. Mr. Tang 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 US 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. Justin Tang. Mr. Tang, please go ahead.

Justin Tang: Yes. Thank you, Jennifer. Hello, everyone, and thank you for joining us for our first earnings call as a public company.

I'd like to take this opportunity to thank our shareholders, as we are now publicly listed on the New York Stock Exchange. Our IPO is an important milestone in our corporate history. We consider it a giant step forward in our mission as we utilize big data and internet technology to build a leading personal finance company in China. We are very early in our growth curve and we believe in the long term there is tremendous potential in this market. In the near term I think a major theme is the economic outlook in China remains uncertain.

So in the near term I think we have three major focus. Our number one focus is to preserve shareholder value during the uncertain economic environment. Our number two focus is to operate our business under the highest compliance standards possible to ensure we are fully compliant in upcoming implementation of our new regulatory standard. Our number three focus will be to deliver healthy and sustainable revenue and net income growth.

Let me now turn to our performance for the third quarter of 2018. I am pleased to report strong financial and operational results in our first quarter as a public company with net revenues increased 83% to RMB830 million and adjusted net income more than doubling to RMB249 million.

Our business continues to recover following the lows we saw in July when the market turmoil was at a peak. We expect this trend to continue going forward. Total loan facilitation is gradually improving. We are decreasing by about 13% during the quarter year-over-year and 32% sequentially from Q2 this year. We expect total loan facilitation in the fourth quarter to increase sequentially from RMB7.6 billion this quarter to between RMB8.0 billion to RMB8.5 billion in fourth quarter.

On the regulatory front I think that there is some good news. I think the regulatory policy today is more visible and more friendly than any period over the last couple of years. We were one of the first P2P platforms to submit our P2P Compliance Self-Inspection Report before the deadline. This is the first step to gain full compliance with the industry reform the government has been rolling out through the National P2P Rectification Offices. And recently government body have mentioned more than a couple of times online lending, P2P lending, are an important part of China's financial system to provide credit to individuals and small business. We fully support the government's initiative and are working closely with them to create a healthier and more sustainable environment for P2P platforms.

We continue to [extend] risk control across our platform. If you look at our Q3 results, we have a decline in loan facilitation that's mainly due to two drivers. Number one driver is the lack of funding during the July and August time. That actually is already over. Right now we have very sufficient funding. The number two driver is we consciously reduced our average loan size because of our concern of external economic environment and credit environment. So you could look at the average loan size that we have on our credit card loan during the Q3. We cut it down by about 20% from our normal period.

After IPO we started to invest more aggressively in our brand. Historically, actually our company had not invested too much in our brand. But we feel during the industrial downturn is a good time to invest in our brand. Recently we signed a multiyear marketing partnership with the NBA which will see our brand integrated with their -- all marketing and media platforms. It is the NBA's first time to cooperating with a company in China's online lending P2P industry. We appreciate the core values the NBA represents and we share the same vision with the NBA, which is to encourage people to chase their dreams.

Although today our online lending platforms still provide for most of our funding, but at the same time actually there are more and more financial institutions recognize the quality of our product and want to partner with us. Recently we started to have a partnership with CITIC Trust, which is one of the China's largest trust company. And this important cooperation is a good opportunity to leverage our advanced technology and extensive experience in operating online lending platforms to assist CITIC Trust in acquiring qualified borrowers and facilitate loans. Together we will jointly develop a new data-driven credit assessment system that combines CITIC Trust's vast amounts of borrower credit data with our big data analytical capabilities and technology.

Overall, we strongly believe we are ideally positioned to benefit from the enormous growth opportunity in China's online lending industry and will continue to execute our strategy to generate long-term sustainable value to our new shareholders.

With that, I will turn the call over to Kevin who will go over the financials. Thank you.

Kevin Zhang: Thank you, Justin. Hello, everyone.

For the third quarter of 2018, we delivered solid results despite a difficult market environment. We continue to invest heavily in our risk management systems, product development, mobile platforms, and big data analytics capabilities to further strengthen our credit rating abilities and to carefully manage risk as the market environment gradually improves.

I'll now have a brief on the financial updates. For interest of time I will not go through every line item, but focus on key ones. And you can refer to more details in our earnings release.

Our net revenue in the third quarter of 2018 increased by 83% to RMB830 million from RMB453 million in the same period of 2017, primarily due to a change in product mix resulting from a significant increase in the proportion of revenue generated by Xiaoying Card Loan, which carries a higher service fee rate compared to the Company's other products.

But when comparing to the results in Q2 2018 our net revenue declined by 22% while the loan volume decreased about 32%. This results from increase of our revenue take rate from 9.5% in Q2 to 11% in Q3. For better comparison I would suggest to use an adjusted revenue take rate as indicator, which equals to our revenue net of provision for accounts receivable and the change in fair value of financial guarantee derivatives. And the adjusted revenue take rate increased from 8% in Q2 to 8.9% in Q3.

Our origination and servicing expenses in the third quarter of 2018 increased by 40% to RMB284 million compared to the same period results 2017, primarily due to the increase in customer acquisition costs from credit side, share-based compensation expenses, and the increase in our collection efforts.

Compared to Q2, it remains nearly unchanged in the total month, but increased from 2.6% of loan volume to 3.8% loan volume in Q3. This was because a large portion of the origination cost is a fixed cost that means our labor cost.

Sales and marketing expense in the third quarter of 2018 increased a lot, both by the amount and the percentage of loan volume, primarily due to increasing advertising campaigns aimed at strengthening our corporate image and increasing investor confidence, such as the IPO related event and the NBA sponsorship.

I would like to highlight income tax expense in the quarter. The effective tax rate decreased a lot due to the corporate income tax rate applicable to our major subsidiary of the Company adjusted to 15%. And we also expect our pre-tax additional deductions for R&D expenses recorded in the third quarter of 2018.

Our net income and our non-GAAP net income in the third quarter of 2018 were RMB198 million and RMB249 million, respectively, about double or more than double that in the same period of 2017.

On the balance sheet side, our cash and cash equivalents as of September 30, 2018, was RMB1,460 million, about an increase of RMB840 million, from both the net proceeds from our IPO and the traffic generated from our operating activities.

This concludes our prepared remarks for today. I would now like to turn the call over to the Operator to begin the Q&A portion of the call. Please go ahead.

Questions & Answers:

Jennifer Zhang: Thank you, Kevin. At this time we would like to open it up for the Q&A. Please know that our Chairman, Mr. Tang, and President Simon and CFO Kevin will take your calls. Operator, please.

Operator: (Operator Instructions) Jackie Zuo; Deutsche Bank.

Jackie Zuo: Hi. Morning, Management. Thanks for taking my questions. I have two. One is the asset quality. I saw during the quarter the 30-to-90 day delinquency ratio rose to about 3%. Just want to get a sense about the rising short-term delinquency ratio. And I saw we proactively shortened/lowered the ticket size of our card loan. Is that because of we're actually seeing some asset-quality pressure from our borrowers? And what's the outlook and trend going forward?

Secondly, the question is on the guidance. Our guidance implies around 6% to 12% quarter-on-quarter volume growth. And we understand fourth quarter is actually -- traditionally it's a peak season interval online borrowing in the credit card loans. So just wanted to get some sense about the reason behind our kind of softer than expected guidance. And also, is good to share what's the mix of the loan volume, like, what percentage of the loan volume will come from card loan and also from preferred loans. Thank you so much.

Justin Tang: Yes. Simon, maybe you answer the first question and I answer the second question.

Simon Cheng: Sure. This is Simon. Hello, Jackie. For the delinquency increase, there basically are two reasons. One is actually we are at a high growth momentum, so as our business grow actually we will see the delinquency grow as well. It's about -- we get the loan size first and we see the delinquency later. This is one of the drivers.

The second driver here, so we saw increase in delinquency in our product. So that's the second driver. Majorly, actually in the card loan we saw slight increase in delinquency. But it's only the slight delinquency. We actually believe our credit card fee for card loan, our major revenue and profit contributor, actually is at still under our early projection.

We'll adjust our credit policy, we'll tighten our credit policy, starting from Q3. Not only we'll lower the ticket size, but also we reject more applications. It's more like a prevention action. We anticipate a more difficult economic environment in Q4 and next year. We want to make sure our credit quality for card loan actually still under our projection, we can have stable credit quality in our portfolio. We can have a stable margin, risk-adjusted margin, so that we can have a stable revenue and profit. It's more for prevention actually for our card portfolio. Again, we still believe the card portfolio, the credit quality, is under our early projection. We have still maintained the same healthy risk-adjusted margin going forward.

Our preferred loan actually we do have a higher delinquency in Q3 than before and that is a challenge for us. This is absolutely a challenge for us. Because for the borrowers, for the preferred loan borrowers, they are pretty much micro small business owners in China. For the micro small business in China actually is a weak sector throughout all this economic downturn. We understand that all this private sector and the huge pressure from the deleverage process. And these micro small business owners who borrow unsecured loan, this is rather a weak point of the whole credit chain. So they are under huge pressure in their liquidity and their ability to borrow and their ability to pay, because their business partners also under pressure. So we do see a very high increased default. So that's both of the contribution for the delinquency increase in the third quarter loan.

And from that perspective we basically scaled down the business of preferred loan. And that will lead to higher delinquency ratios as well, because you stop growing the business. Your older business deals have delinquency and that was also the driver for the increase in delinquency.

Jackie Zhu: Thank you very much.

Justin Tang: Jackie, for your second question is the Q4 loan facilitation growth. Like I mentioned in my call, basically I say our near-term key focus, number one is to preserve shareholder value. Because I think one of our key ability is closely monitor the data and real-time adjust our strategy and policy so we be able to manage our risk on a very much real-time basis. So in the near term, our characterization of external environment is uncertain economic environment and the challenging credit environment. So as a result, at this moment we don't want to put the growth in our number one priority. Our number one priority is to preserve shareholder value.

But at the same time, I still say, number three, we will continue to generate a healthy and sustainable growth. So that's our operating forecast. If you look at underlying driver, like Simon also mentioned, actually our credit card loan we continue to grow in terms of number of loans being facilitated. But at same time we reduce average loan ticket size by 20% to even 25%. So although the loan amount continue to grow, by the combining with the lower ticket size the growth in the loan facilitation amount is not that obvious.

Then on the preferred loan, because of the operating environment of SME owners are very difficult these days and our preferred loan did suffer a higher than expected loss than our earlier estimates. And as a result actually over the last three quarters we have been consistently reduce our preferred loan business. You know, I think we keeping saying is if you look at the core competence of our company, core competence of our company is use the internet and use data to do the different -- do the differentiated risk of pricing. So in the future, if you look at our core business, really is online loan facilitation, use data and internet technology.

So based on what we've seen and what's our plan at this moment we target RMB8 billion to RMB8.5 billion for Q4. Certainly we hope to do better.

Jackie Zuo: Thanks a lot. Can I have a follow-up question on the delinquency rate? Is that possible, to share the breakdown of what was the delinquency rate for card loan and the preferred loan, just to make sure I understand this correctly?

Justin Tang: Simon, you want to answer that?

Simon Cheng: Yes. Actually, at this moment we don't share the separate delinquency for each product. But on a general guidance, is our delinquency and the loss for card loan is pretty consistent as before and still in our estimate. And the preferred loan, it's much higher than our estimate. And we we don't share the detailed breakdown, but that's a general picture of the situation. And the volume mix changed also because as we scale down the preferred loan business, the mix of our portfolio actually, servicing portfolio actually more towards the online lending and card loan.

Justin Tang: Yes, Jackie, one way you look at it is if you look at the newly facilitated loan, our card loan is a dominant part of our business. Our card loan now is probably -- almost every month is probably in terms around like 10 times our preferred loan amount, so in the newly facilitated loans. So to understand our businesses going forward, you should just focus on card loan.

For the existing loan book, because our risks are fully provisioned and fully being sell to the customers covered by the insurance company, so you actually don't need to worry about the existing loan book that much. That's the reason I think we feel this is a better way to present our business, just on the combined basis.

Jackie Zuo: Thank you so much.

Operator: (Operator Instructions) John Cai; Morgan Stanley.

John Cai: Good morning, Management. I have two questions. First is on the adjusted net take rate and we see an improvement on the Q-on-Q basis to 8.9%. So I understand there's a product mix shifting toward the card loan with higher fee rates. So just wonder if there's other reasons driving up the net take rate. And can we have more colors on the APR and the provisions and funding costs breakdown of the net-net take rate?

And then the second question is on the cash balance. After the IPO we have pretty sufficient liquidity with around RMB1.5 billion cash, so just wondering how will we want to utilize the cash. Thank you.

Kevin Zhang: Hello, John. I will take the first one and the second one. With regards to our revenue take rate, yes you're absolutely right, that our revenue take rate increased in Q3 when compared to Q2 is mainly for the change of the product mix, a greater proportion of our card loans now we have on the books.

But on forward looking, we do expect that will have some slight increase to our APRs in the Q4 going into 2019, but mainly due to our decisions when we're looking at the total business environment and potential risk exposures. So but currently I would like to suggest that the revenue take rate in Q4 will remain stable when compared to Q3.

So second question, with regards to cash and cash equivalents, now we have a lot of cash.The increase in cash in Q3 is both from the IPO proceeds and our cash generated by operating activity. We are planning for how to better utilize cash. For example we are looking for doing more investment in our advertising and marketing activities such as the NBA and other activities.

And on the same time we will keep investing on our human capitals. And that's one of our key drivers that differentiates us from other companies. And currently we just have those two major objectives to use our cash. And we will keep you posted if we have any business issue, if any acquisition or other kinds of use of our proceeds. And we will keep everyone posted. Thank you.

Justin Tang: Yes, John, just to add I'm Justin. So as you can tell, we obviously have a strong balance sheet with a bunch of cash and no debt. And our business continues to generate cash as well. So we will constantly evaluate what's the best way to use our cash to generate the best shareholder value. I think we are very open-minded. And the external environment obviously is very dynamic, but we will very much evaluate what's the best way to utilize, as to provide the best value to shareholders.

John Cai: Okay. Thank you.

Operator: Michelle Li; AMTD.

Michelle Li: Thank you, Management. I have two questions, the first on the funding side. Could you please share with us your plans in terms of the funding mix? Do you plan to expand your funding from the financial institutions as well?

My second is the customer acquisition cost. Could you please share with us maybe the quarterly trends of your average customer acquisition costs for each borrowers and for investors as well? Thank you.

Justin Tang: Yes, I can take that. So for funding sources, actually during the Q3 our online lending platform continued to provide majority our fundings, 80%-plus of our fundings, the financial institutions provided less than 20% for our fundings. One of the key theme is actually we have a lot of financial institutions actually wants to provide funding to us. But actually if you go to our APP every day you can see almost 80% to 90% of the time we have nothing to sell. So basically we recover very strongly from the turmoil period that the industry went through during the July and August. So our investors continue to demonstrate strong confidence to our product.

So right now, honestly, is I think we have more appetite for our loan product than we be able to supply at this moment. In the long run I think we will increase our institutional funding percentage. In the near term we just don't have too many extra assets to supply to them.

Yes, the second question maybe Simon or Kevin can address.

Kevin Zhang: Yes. With regard to our customer acquisition costs, we just found that the customer acquisition for the both, from credit side and from wealth management side, they are very stable. We expect that acquisition cost for our credit side will be around 120 RMB per new account. And for the investment side the (acquisition cost) will be RMB330 for new accounts. But of course I think we will have some increasing from the investment side per acquisition cost. Because, as said previously, we actually do very little in advertising campaigns, but now we have to do some new investment, do some investing in that, for example, the NBA sponsorship and other advertising projects.

Justin Tang: Michelle, I hope this will be helpful for your questions.

Michelle Li: Yes. Thank you very much.

Operator: (Operator Instructions) Okay. Seeing no further questions in the queue, 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 got the 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.