

X Financial (XYF)
Second Quarter 2019 Earnings Conference Call
August 19, 2019 08:00 AM Eastern Time

Executives:

Jennifer Zhang, Investor Relations
Justin Tang, Founder, Chief Executive Officer and Chairman
Simon Cheng, President
Kevin Zhang, Chief Financial Officer

Analysts:

John Cai, Morgan Stanley
Matthew Larson, National Securities

Presentation

Operator: Operator: Hello, and welcome to the X Financial Second 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 your host today, Jennifer Zhang. Please go ahead, ma'am.

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, CFO. Mr. Tang and Mr. Cheng will give a brief overview of the Company's business operations, followed by Mr. Zhang, who will go through the financials. 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. Justin Tang. Mr. Tang, please go ahead.

Justin Tang: Thank you, Jennifer. Hello, everyone. We are pleased to report a solid quarter where we made significant progress across a number of different aspects. Our business momentum remains strong, with the quality of loans facilitated on our platform improving slightly, and the funding from institutional investors expanding.

I'd like to highlight some of these achievements. First, the industry regulatory environment is still challenging during the second quarter of this year. No matter what the regulation trends are, we are making ourselves thoroughly prepared to be qualified and compliant with new regulations in order to protect investors and shareholders' benefits.

The P2P industry continues undergoing so-called check and audit process per regulators' requirements. And we are complying of regulators' so-called Three Decline requirement by decreasing our loan balance on a number of active lenders. There are few potential outcomes for the P2P industry. At this moment, it remains unclear. So we are not sure if the so-called registration will ever be completed.

At the same time, we are working with the local regulators to explore the possibility to transform part of our business into micro-credit loan company.

Second, the high-quality loans on our platform and our strong reputation is helping us to attract more institutional investors. During the second quarter of 2019, funding from non-individual investors accounted for around 26.7% of the loans facilitated through our platform, a significant improvement from 10.4% in the first quarter.

Demand from institutional investors for our high-quality assets remains strong, and will gradually reduce our funding costs over time. Financial institutions have extended credit lines to us in an amount of approximately RMB26.4 billion for us to facilitate loan transactions on our platform, which reflects the trust that financial institutions have in the quality of our assets and the strength of our risk management. So we are pretty confident that if necessary, we can use institutional funding to maintain the stable growth of our business without any interruption.

Third, our delinquency rate improved on a sequential basis, as we continue to invest in our risk management systems and the technology. We are diversifying our customer acquisition channels as well through partnerships with e-commerce platforms and other channels with better customer quality.

Lastly, Xiaoying Wallet, our recently launched revolving credit product, grew rapidly during this quarter, with transaction volumes jumping significantly to RMB970 million from RMB200 million in the last quarter, and outstanding loan balance increased to RMB578 million as of June 30, 2019 from RMB177 million as of March 31, 2019.

Xiaoying Wallet was developed with the needs of our customers in mind, and we leveraged our sophisticated data analysis capabilities and advanced technology infrastructure to offer the best product in the industry.

In conclusion, we are confident in our future growth prospects and ability to create long-term value for our investors and shareholders. We will continue to provide the best user-friendly and convenient

financial services to borrowers, and help them meet demand for consumption, and grow our online consumer lending business.

This will conclude my remarks. Now, I'll turn over to Simon Cheng, our President.

Simon Cheng: Thank you, Justin. Hello, everyone. We are very pleased to see the quality of our loans has improved, and the delinquency rates for both 30 to 90 days and 90 to 180 days went down sequentially, which reflects our strong risk management capability. Since later 2018, we have taken prudent approach in our credit policies, and it is very good to see stable and improved credit quality during this uncertain macro environment. We will continue our prudent approach in our credit policies in the later part of 2019.

Besides, we have expanded our funding channels to banks, trust companies and other financial institutions, which further strengthens our funding cost and diversify our funding sources. In addition to that, we are expanding our borrow base by cooperating with other fintech companies.

We are very happy to see Xiaoying Wallet, our recurring consumption product, is growing in importance of our business as a result of strong demand in the market. As Justin has mentioned, the number of transactions of Xiaoying Wallet in the second quarter increased by 347% quarter-over-quarter.

The number of registered and approved users of Xiaoying Wallet was 542,752 as of June 30, 2019, increased from 192,891 as of March 31. Xiaoying Wallet is expected to maintain strong growth momentum and gradually account for a larger percentage of our overall business.

We are confident we will continue to deliver good results going forward in the challenging environment.

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

Kevin Zhang: Thank you, Simon. We delivered solid financial results during 2019 second quarter despite the regulatory uncertainties remained. The non-GAAP net income attributable to X Financial shareholders increased to RMB342.5 million during this quarter, a 57% increase compared to our results in the first quarter.

We continued to expand our relationships with banks and trust companies, as well as other institutional funding partners. 26.7% of our funding in the second quarter is from the non-individual investors. And we expect 45% to over 60% of the funding will be supported by the non-individual investors in the third and fourth quarters respectively.

The overall funding costs remained stable, while we foresee a decreasing funding cost from financial institutions in the second half year of 2019, as low as 8% annually.

In the interest of time, I will not walk through every detailed line. Please refer to our earnings release for further details.

Net revenues in the second quarter of 2019 is RMB810 million, a 4.2% increase quarter-over-quarter. The revenue take rate is 7.96%, slightly a 0.1% decrease compared to the revenue take rate in the fourth quarter, since the product mix is relatively stable and the APR of our main product, card loan, remains unchanged.

The origination and the service expense, as a percentage of loan volumes facilitated, increased by 0.65% from 3.5% in Q1 to 4.15% in Q2, primarily due to an increase in consumer operating cost for the recent launch of the revolving credit product, Xiaoying Wallet.

We are pleased to see one of our major subsidiaries classified as a software enterprise in May 2019, while makes it fully tax exempt of enterprise income tax of 2018, and is subject to our preferential EIT tax rate of 12.5% from 2019 to 2021. This contributes to our income tax benefit of RMB140 million during this quarter, and we expect that the effective tax rate will be around 15% in 2019, a 45% decrease compared to just in 2018.

Besides, we expect the loan facilitation for the third quarter of 2019 to be approximately RMB10.5 billion.

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

In conclusion, we are pleased with our operational and financial performance this quarter, and will continue to roll out initiatives and apply technologies across our business to improve operational efficiency and create long-term sustainable value for our shareholders.

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

Questions and Answers

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

John Cai: I have a few questions, and the first one is on the regulations. Can you talk about what's the latest communications with the regulators? What are the expectations on the pace of the Three Decline? And also, Mr. Tang mentioned that you were talking about a transit in some of the business to a micro-credit online lending license. So just wondering if there's any colors or further details on that front. So how many portion will go there? And when do we expect the license to be resumed, because the U.S. suspended.

And the second question is about the growth. Naturally, we mentioned that the risk has improved sequentially, and we also have over RMB20 billion institutional funding stand-by. So just wonder what kind of balance growth can we expect for the second half for this year?

And the third question is on the product. I think we have seen very strong momentum of the Xiaoying Wallet. Based on my calculation, the ticket size seems to be very small; it runs around RMB300 to RMB400. Can the management also share some take rates on tender and profit contribution of this product in particular, really in relations to the customer acquisition cost? Because I also see that origination and servicing cost has also increased.

So just wonder if we look at Xiaoying Wallet standalone, can they break even after the customer acquisition costs? And what sort of contributions do we expect in the future?

Justin Tang: Yes, John, thanks, yes. So I will address the first and the second question, and Simon and

Kevin can answer the third question.

In terms of regulation, like I mentioned on the call, at this moment, the prospect of the registration remains unclear. Basically, we are working with the local regulators that require us to decrease our loan balance on our P2P platform, and also decrease the number of active lenders. And we are complying with that.

At this moment, out of our RMB20 billion loan balance we have, there are under 65% in our P2P platform. So we have declined by around RMB500-800 million every month. And we'll go ahead with the registration process, we don't know yet.

At the same time, we are working with regulators to explore the possibility of transforming part of our business into a micro-credit company. But this needs to work together between the local regulator and the regulator. And so we are working pretty actively with them, and if and when that will happen in a way, we don't know yet. But again, we are pretty well prepared in all fronts, and no matter how the regulation will go, we'll be able to maintain the scale our business without much interruption.

So the second, in terms of growth prospects, we will give guidance for the third quarter. You see our second quarter, we have some small sequential growth from the quarter. I think in Q3, we'll see some further sequential growth from Q2, maybe at single-digit. And I think Q4 will be better as well. At this moment, we only give visibility for the second half of this year; we just don't want to make a premature prediction for the business in next year, because external economic environment still is fairly uncertain, and the general credit environment is still very challenging.

But the funding is not bottleneck at all. We actually have sufficient funding to support the growth of our business. I think the key really is to acquire the quality loan demand, and we're very careful, only we will facilitate the quality loan demand.

Kevin and Simon can answer the Wallet question.

Simon Cheng: Yes, Xiaoying Wallet is a recurring consumption product. So it means the customer is supposed to use the product very frequently, and with a lot of transactions and our general transaction size is about RMB300 to 400. This is a small-ticket transaction.

But the customer will continue to use it for a longer time, which means a longer lifetime for the customer, because it's a consumption loan. And this also has a better credit quality and also because it'll last for quite a long time, then our revenue source will be quite a diversified, not only from interest income.

So with all these strong benefits from this product feature, actually currently, we are trying to increase the volume of these active frequent consumption uses for our product. We see very strong demand in the market, and we see very strong growth in the future. So our focus right now is not profitability, but given the data we have, we expect that the customer we've acquired can generate positive revenue after a year.

Kevin Zhang: Yes, and I will give some more details about this product after Simon. Actually, when we are talking Xiaoying Wallet, we categorize it into three subsegments. One is the consumption, and the second, we call kind of installment. The third will be cash advance.

For about 2.8 million number of transactions, all the Xiaoying Wallet product, about 2.7 million will be the consumption. And the ticket size for the consumption is only about, as Simon mentioned, RMB200-300 per transactions. But when we talk about the installment and the cash advance, it will be around RMB1,000-3,000 per transaction.

For the transaction, just like we use our credit card to purchase (inaudible), so actually, we will provide around a 7-day grace period. So the tenure for those transactions will be very short. So when we're talking about the installment and the cash advance, it will be around 7 to 9 months, a little bit similar to our product, card loans, and as we know, those recurring products usually have a longer use life compared to our loan products.

So after the first several months, we usually like to invest more on our customer acquisition cost. That means after first several months, we expect that will be an operating loss for the segment. But after around 1 year or 1 to 2 years operating, we expect the total business will be breakeven.

John Cai: Thank you. Can I have a follow-up on the customer acquisition costs? So just wonder what's the trend and what's the cost we're paying for every Xiaoying Wallet customer. And a new question actually is about our cooperation with ZhongAn. What's the mix at the moment, and what's the cost, and any new partners we are working with?

Kevin Zhang: Okay. I will add some colors first, and then maybe Simon and Justin can help you. When we're talking about customer acquisition cost, we now tend to invest about 150 to around 200 to acquire a new active customer for the Xiaoying Wallet. And we expect the average acquisition cost will remain stable in the second half of 2019. That's our foreseeable view for the customer acquisition cost for the Xiaoying Wallet.

When we're talking about our cooperation with ZhongAn, yes, actually, about 80% of our business was now secured by ZhongAn Insurance. In Q1, it was about 82%, and that means in this quarter, we improved that slightly. And now we are still seeking the cooperation with other insurance company and guaranteed companies to increase the percentage of transaction supported by other partners. But we are still on our way, but we wait to have some partners or pipeline to negotiate with our vouchers.

Justin Tang: Yes, as Kevin just said, actually, ZhongAn is still the largest insurance partner at this moment, and we have a very good relationship with ZhongAn. And at the same time, quarter-by-quarter, the loan insured by ZhongAn has decreased. We are actively seeking other partners, including insurance companies, or some guarantee companies. We have get a good response from their part as well, and we continue to diversify the guarantee partner for our business.

John Cai: Thanks a lot. That's very helpful.

Operator: Matthew Larson of National Securities.

Matthew Larson: I got on the conference call a little late. So if I'm asking a question that you addressed, I apologize. You gave guidance in the earnings release for the third quarter. Do you have guidance for the full year?

Kevin Zhang: Actually, we set a very safe goal for the fourth quarter. So we're talking about the whole year, we expect around RMB40 billion to maybe RMB41 billion loans facilitation amount for the whole year.

Matthew Larson: All right. And so it's reasonably flat.

Kevin Zhang: Yes.

Matthew Larson: And that's because you're replacing your peer-to-peer funding with more institutional funding? Is that why that's the case?

Justin Tang: I think that's not a major driver because actually, we took a very prudent approach in our credit policies at this moment. The environment is quite uncertain at this moment, so we really try to make sure we have good quality for our assets. So we have a stable strategic increase. This is the plan at this moment.

Matthew Larson: Okay. By the end of the year, could you give me your goal as far as what percentage of your business will be institutionally funded?

Kevin Zhang: We said by the end of this year, which is over 60% of our funding will be from the financial institutions.

Matthew Larson: All right. And it seems to me that's what the regulators are pushing for, so that sounds like a majority and a big move up from where you were this time last year. Let me see; your stock, which came public at 14 is \$2.60, trades well below book value. And the estimates I'm using, maybe from my previous caller, the Morgan Stanley analyst, at this point, it looks like you're trading at 2.5 times earnings or maybe thereabouts. Is there any thought of a dividend or buying back some shares at this low level in addition to the other work you're doing?

Justin Tang: We made a \$15 million dividend for fiscal year 2018, and I think we'll continue to make a dividend in 2019 as well. We have not done a stock repurchase yet. One of the reasons is the liquidity of our stock is fairly low. And so it is pretty hard for us to buy much, and if we're buying, we will further reduce the liquidity in the open market, it's not going to be good. And the second also is because there are different possible outcome for the regulation, we want to reserve some cash on hand in case we need to fund some financial institution per regulators's requirement. So at this moment, I think we're just going to have a pretty stable dividend policy.

Matthew Larson: All right. That sounds good. And when do you expect to announce the dividend for 2019?

Justin Tang: We do it once a year, so will be after fiscal 2019.

Matthew Larson: So 6 months at least. Okay. Well, it looks like your business is humming along pretty well. And I guess the uncertainty is the regulatory rules that everybody is waiting for, but I would assume a well capitalized firm like yourself with a large cash balance, which is trying to raise their institutional funding, would be one of the survivors in a business that is consolidating. And you would pick up market share at one point. So that's what I would be expecting. So thank you, appreciate it.

Justin Tang: Thank you. Yes, we certainly think so, yes. Thank you.

Operator: Thank you. And that is all the time that we have for questions. I would like to return the floor to Jennifer Zhang for any closing comments.

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

Operator: Thank you. The conference call has now concluded. Thank you for attending today's presentation. You may now disconnect your lines.