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EDITED TRANSCRIPT
Q4 2018 360 Finance Inc Earnings Call

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PRESENTATION

Operator

Good day, and welcome to the 360 Finance Fourth Quarter and Full Year 2018 Earnings Conference Call. (Operator Instructions) Please note, this event is being recorded. I would now like to turn the conference over to George Shao, Head of Investor Relations. Please go ahead.

George Shao *360 Finance, Inc. - Head of IR*

Hello, everyone, and welcome to 360 Finance's Fourth Quarter and Full Year 2018 Earnings Call -- Earnings Conference Call. The company's results were issued earlier today, and were posted online. So joining me today on the call are Mr. Jun Xu, our Chief Executive Officer; Mr. Haisheng Wu, our President and; Mr. Jiang Wu, our Chief Financial Officer; and Mr. Yan Zheng, our Vice President. We will start the call with our prepared remarks and conclude with Q&A session.

Before we continue, I will refer you to our safe harbor statement in the earnings press release, which applies to this call as we will make forward-looking statements. Also, this call includes discussing of certain non-GAAP financial measures. Please refer to our earnings release, which contains a reconciliation of non-GAAP measures to the most directly comparable GAAP measures.

And finally, please note that unless otherwise stated, all figures mentioned during this conference call are in Renminbi. I'll now turn the call over to our CEO, Mr. Xu.

Jun Xu *360 Finance, Inc. - CEO & Director*

Okay. Good morning, good evening, everybody. Thanks for joining the call. We're very proud of the results we were able to achieve in the fourth quarter and for the last year. 2018 was a turbulent year for the sector. Towards the end of 2017, we saw the arrival of Circular 141, which had a profound impact on the sector, and the impact lasted into early part of 2018.

And then in the first half of last year, as part of the deleveraging efforts from the Chinese Government, the liquidity in the banking system, also the cost of funding was tight for everybody. Then towards the second half of the year, during August, we saw the P2P fiasco across the country. Overall, the sector was under lot of pressures from both regulatory and the market conditions.

We were very proud of being able to achieve phenomenal growth, despite the tough macro environment, and specifically we're proud of adding 9.2 million new borrowers with credit line and with -- that's how we measure our success. We want to be able to get more credit to Chinese consumers. So we added 9.2 million new borrowers with approved credit line with the company in the last year. We're very proud of that.

We're proud of our ability to keep the asset quality at industry-leading level. And as you can see from the earlier release, the M3+ NPL ratio was at 0.9%, way below what we see in the banks' credit card or consumer lending business. Our M6+ Vintage loss was 1.6%, the highest vintage, quarterly vintage. And on average they're below 1.5%. We're proud of our industry-leading fraud rate of 0.2%, and thanks largely to 360 Group's security DNA and anti-fraud ability.

Thirdly, I think, we're very proud of the resilience and the sustainability during the last year. Our funding from institutional banking

partners was 78% in terms of loan originations in the last quarter of last year, that's the origination. Even if you look at from a balance perspective, out of the RMB 43 billion outstanding balance, 77% were funded by our institutional partners. So that's really behind the extraordinary growth we saw last year. As we all know, a lot of the pressure was coming from the funding slide last year and because of our brand, our extra low NPL ratio and our stature in the Chinese economic system gave the banks confidence in working with us on a continual basis, therefore, giving us a structural advantage in terms of funding availability and funding cost.

So behind those numbers, we believe we will continue to benefit from 3 perspectives going forward, where we comment structural advantages compared to the other players. And I think firstly, as I mentioned, funding. We're adding more banks to our partnership list every month. Our funding position is better than any previous period. And given our position in the industry, 360 as a household brand and as a major Internet company here in China, certainly help us open doors with a lot of banks.

And secondly, in terms of data, given our partnership with 360 Group, we have access to the security data, which is critical to the anti-fraud capability and fraud as you all know is a major source of risk for this type of small ticket size loan products. So we're very proud of being able to leverage those data and use them effectively in anti-fraud.

I think thirdly in terms of customer acquisition, thanks to the branding power of 360 as a household brand in China, thanks to the 500 million active users from 360 Group, we were able to grow the customer base at a reasonable customer acquisition cost. We believe we will continue to benefit from the brand and also from the collaboration with 360 in terms of customer acquisition going forward.

So that's a brief overview of the last year.

Looking ahead, we're confident we'll be able to maintain the growth momentum into this year. We gave the guidance of top line between RMB 8 billion to RMB 8.5 billion in our release. In the meantime, we are experimenting some new models, in particular, we've seen some early results from our efforts with regard to small and micro business lending. We put together a small team last year doing a pilot. The pilot has given us encouraging early results. We're rolling that out. As you all know, the government and the regulators are pushing hard for small, micro business lending here in China, and our banking partners are demanding that. We don't think anybody in China has really cracked the code in using mobile Internet, Big Data and AI to solve the micro and small business lending opportunity. As one of the leading telecoms in China, we're determined to give it a shot and see whether we can solve that problem because that's a bigger market than the consumer lending itself.

Consumer lending is about RMB 10 trillion in terms of assets, SME lending between RMB 3 trillion to RMB 4 trillion depending on how to cut the sector, and so it's a bigger upside, it's a product the government and the regulators are pushing for. And basically it also has unlimited low cost of funding. So if you generate those type of assets there is a huge demand from all the banks here in China. And the other thing we're experimenting is to provide our partners with some of our capabilities in anti-fraud, in credit risk scoring, modeling, AI capabilities and share those with our partners and help them to build the capabilities to do online lending.

So looking ahead, we're confident the main -- the current consumer lending business will continue the growth momentum and in the meantime, we're experimenting some new ideas to take the business to the next level.

Let me pause here and pass it to our CFO to talk us through some of the financial numbers. Thank you.

Jiang Wu *360 Finance, Inc. - CFO*

Thank you, Jun. This is Alex, the company's CFO speaking. And we think our financials are speaking for themselves in the earnings report released. And just a few highlights to share with you. First, the growth, just as Jun mentioned, from the financial perspective, we see tremendous growth for revenue in both the top line and bottom line. And the revenue growth from RMB 788 million in 2017 to RMB 4.4 billion in 2018, which represent more than 4.6x growth.

Our operating margins grown from RMB 210 million to RMB 1.66 billion in 2018, represents growth of more than 6x. And if we adding back the share base cost, which give us the non-GAAP operating income, we see even higher numbers. And for the net incomes, we see the growth is roughly 6x as well. And if we adding back the share-based cost, it gives us the non-GAAP net income growth to almost

ten-fold i.e., from RMB 165 million in 2017 to more than RMB 1.8 billion in 2018. That is the first highlight we want to share with you.

The second highlight is our cost structure. As you can see from our reports, our sales and marketing expense is relatively high. Last year, it was RMB 1.3 billion. The reason is we don't think this as the expense. We think it's a long-term investment because every customer we invite into our platform will contribute to our business in the coming few years. So it's more like long-term investment.

Thirdly, we want to address the operating efficiency by showing you the operating margin. In 2017, the operating margin is 26.7%, which was -- which increased to more than 50% in 2018. I mean, the non-GAAP operating margin i.e., every single renminbi as a revenue we earned doubled as an operating income. The efficiency is largely -- the improvement of efficiency is largely due to the scale of economy and our management team's dedication to streamline the operation -- daily operation.

The last thing we want to highlight is our cash position because last year we successfully finished our -- completed our IPO process and before that we did one round of pre-IPO financing plus the operating cash flow, it gives us a strong cash position for this year. And last year, we see the total cash is RMB 2.8 billion. Obviously, half of them are collateral to funding our business, but the rest is some sort of a free cash flow for us to expand our business and to do more pilot project.

And I will pause with that, and then starting for the Q&A session.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) The first question comes from John Cai of Morgan Stanley.

John Cai *Morgan Stanley, Research Division - Research Associate*

So I think, my first question is about the growth driver. I can see that we added around RMB 10 billion outstanding loan balance in the fourth quarter, I just wonder if we look at the growth driver behind in terms of the average outstanding loan per borrower and the number of borrowers, how would these 2 factors drive the loan growth for the first quarter and what's our expectation of these 2 drivers in 2019? Obviously, we have very strong guidance here. That's the first question. And the second question is about customer acquisition. So what is the customer acquisition cost for the fourth quarter and what's the historical trend and what do we see in 2019? And the third question, I think, is about the SME lending. So about that strategy obviously it's still in the -- probably in the pilot stage, but I just wonder as on high lenders what's our edge in that? I think typically it seems very off-line heavy operations involved in the lending.

Jun Xu *360 Finance, Inc. - CEO & Director*

Thank you. I'll talk about the first question, then I'll pass to our President, Mr. Haisheng, to answer your second question. And probably I'll pick the third question after that. In terms of growth driver, fundamentally, the growth was driven by the funding advantage in the sector. So a lot of companies had funding challenges in the last year. And we're able to fund the growth. I think that's the first point. In terms of -- on the customer side, and it's predominantly acquisition of new borrowers, and we added a lot of new borrowers. It's also a little bit of higher balance per borrower as we get more comfortable with some of the existing customers where we regularly review the credit line and increase line for those good customers. And thirdly, it's also driven by the repeat borrowers you see on the platform and as you can see from the press release over half of the origination come from pre-existing customers. So it's a combination of number of new customers, higher balance per customer and better penetration and repeat borrowing from existing customer, but predominantly it was driven by new borrowers. It's a huge market, we're a tiny portion of the market, the upside is still huge, so we want to grow our borrower base last year and this year as well. Hopefully that answers your first question. And with that, I will ask Mr. Wu to talk about the customer acquisition point.

Haisheng Wu *360 Finance, Inc. - President*

Can I speak in Chinese?

Jun Xu *360 Finance, Inc. - CEO & Director*

Yes, you can talk in Chinese, I can translate for you.

Haisheng Wu *360 Finance, Inc. - President*

(foreign language)

Jun Xu *360 Finance, Inc. - CEO & Director*

Okay, there are 3 points. I think first point was, there was a huge opportunity in the market and our funding cost -- our acquisition cost has been stable over the last year overall. And we verified the economic model and we want to grasp the opportunity in the market and grow our customer base when the market still has a lot of untapped potential. Secondly, looking into this year, we believe we'll continue to acquire new customers in aggressive manner. One important factor is that we are able to tap into some of the leading customer acquisition channels and, for example, those Tencent-related channels we're able to penetrate into now. Thirdly, with the new regulation we see and with the new development in the industry, we anticipate less competition in the sector, enabling us to acquire more customers at reasonable costs. On your SME question, as I said, SME traditionally has been a tough business globally because of: One, customer acquisition cost is high. Two, lack of data in China making it difficult to assess the risk. Therefore, it was by and large off-line business. But we have experimented some models, which we believe had potential to solve those problems using the latest technology and Big Data. For example, lot of the customers in our portfolio, they actually operate online shops at Taobao, JBL, Pinduoduo, and they are good data on those platforms, which enable us to make sound credit decisions. And for example, we have seen good examples of leveraging the tax data and customs reporting data and triangulate those with other data to help us determine the risk level of a particular SME. So with more data and more transparency, we actually believe we are on the cusp of a fundamental shift just like what we see couple of years ago in online consumer lending, really the facial recognition technology, the Big Data, the AI model made it possible to the consumer lending. Five years ago, it was inconceivable to offer a loan to a consumer without actually seeing him. So 360 as the leading Internet company in China, we have a lot of customers in the sector. It serves a lot of SMEs in traditional advertisement business as we have good insights into the business nature of those companies, we'll have access to them. We also are building collaboration with some third-party data vendors and aggregating different sorts of data to enable us to perform a sound credit assessment on these companies. So as I said, no one really has cracked the code, but we want to give it a try.

Operator

The next question comes from Daphne Poon of Citi.

Daphne Poon *Citigroup Inc, Research Division - Associate*

So my first question would be about the funding side. So we understand that on your institutional funding partners, it used to be relatively concentrated with the city and rural commercial banks, which is now potentially subject to the regulatory constraints in terms of their cross-regional lending business. So I'm wondering if you can share more details in terms of your progress in diversifying your funding partners and maybe how is the mix between different types of financial institutions currently? And also further on the funding size, we do see the independent credit environment improving recently. So I'm wondering whether that has helped on your funding costs and your funding availability recently and what is your current funding cost in 4Q or 2019 year-to-date? And the second part of the question is, I want to check on the asset quality trend. So given there is some macro slowdown concerns, so I'm wondering like what is your latest delinquency rate and whether you see any sign of pickup in the early default. Because you see that this time you only disclosed this M6+ Vintage delinquency curve versus previously we used to have the M3+ curve. So we like to get better stance like what is the early loss rate trend?

Jun Xu *360 Finance, Inc. - CEO & Director*

Okay. Let me take on the funding question and then I'll ask our VP for risk management to answer your question related to asset quality trends. So over the last year, we have shifted our funding structure multiple of national banks. We have started working with banks like ICBC in the last year. So original banks are a smaller portion of the funding structure. We have done some stress test. So we assume the regulation would just happen like what you described. We are concluding that our funding stability will not be affected and the impact on our funding cost will be minimal, given the number of banks and consumer finance companies and trust companies we have partnership has gone up a lot. We, of course, worried a lot about regulatory changes and we've done some series of stress tests, and we were quite happy with the result of the stress testing. On the liquidity easing, it is having an impact on our funding cost. The funding cost, as I said earlier, last year was on the rising trend because of the tight liquidity deleveraging from the government, and also because of the P2P

accidents and all that, we're seeing our funding cost stopped going up, being very stable and with some of our funding partners we are seeing funding cost going down. So yes, we are benefiting, not significantly, but we are benefiting from the easing liquidity situation in China. I'll ask Mr. Yan Zheng to answer your question on asset quality trends.

Yan Zheng *360 Finance, Inc. - VP*

(foreign language)

George Shao *360 Finance, Inc. - Head of IR*

So we discussed M3+ delinquency ratio of 0.92%. We believe delinquency ratio is very low in terms of industry average level. So for example, the M3+ ratio of the credit card industry is from 1% to 2%. With the innovation of our AI technology as well as the accumulation of databases, we are confident to keep the leading role of risk management among the market.

Yan Zheng *360 Finance, Inc. - VP*

(foreign language)

George Shao *360 Finance, Inc. - Head of IR*

According to what we see, the annualized risk performance of our users is stable. So we don't see any material impact to the credit quality in the near future. We keep monitoring risk behavior from user side, update our risk management model, and the strategy to ensure our loan assets' quality is reasonable and under control.

Operator

(Operator Instructions) This concludes our question-and-answer session. I would like to turn the conference back over to George Shao for any closing remarks.

George Shao *360 Finance, Inc. - Head of IR*

Okay. Thank you once again for joining us today. So if you have further questions, please feel free to contact our Investor Relations, so the contact information provided on our website and in our press release. So thank you, and goodbye.

Operator

The conference has now concluded, thank you for attending today's presentation. You may now disconnect.