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Q2 2021 360 DigiTech Inc Earnings Call

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the 360 DigiTech Second Quarter 2021 Earnings Conference Call. Please also note, today's event is being recorded. At this time, I'd like to turn the conference call over to Ms. Mandy Dong, IR Director. Please go ahead, Mandy.

Mandy Dong ***360 DigiTech, Inc. - IR Director***

Thank you. Hello, everyone, and welcome to our second quarter 2021 earnings conference call. Our results were issued earlier today and can be found on our IR website. Joining me today are Mr. Wu Haisheng, our CEO and Director; Mr. Alex Xu, our CFO and Director; and Mr. Zheng Yan, our CRO.

Before we begin the prepared remarks, I'd like to remind you of our safe harbor statement in our earnings press release, which also applies to this call. We may refer to forward-looking statements based on our current plans, estimates and projections. Also, this call includes discussion of certain non-GAAP measures. Please refer to our earnings release for a reconciliation between non-GAAP and GAAP ones. Last, unless otherwise stated, all figure mentioned are in RMB.

I will now turn the call over to our CEO, Mr. Wu Haisheng.

Haisheng Wu ***360 DigiTech, Inc. - CEO & Director***

[Interpreted] Hello, everyone. I'm very happy to report another quarter of record-breaking operational and financial results. During the quarter, financial institutions originated RMB 88.5 billion loans through our platform, marking another record high, up 5-0, 50%, Y-o-Y and 19%, 1-9, Q-on-Q. After reaching RMB 100 billion milestone in Q1, outstanding loan balance continued to grow to RMB 111.6 billion in Q2, up 5-0, 50%, Y-o-Y and 15%, 1-5 percent, Q-on-Q. Total revenue was RMB 4 billion in Q2, up 20%, 2-0, Y-o-Y and 11% Q-on-Q. Non-GAAP net income was RMB 1.62 billion, up 71% Y-o-Y and 15%, 1-5, Q-on-Q.

Despite a continuously changing macro and regulatory environment, we have delivered 5 consecutive quarters of record-breaking results. Over the past few years, we have built a comprehensive operational system that demonstrates remarkable resilience through cycles. To be more specific, our diversified users, acquisition channels and scenarios allow us to effectively hedge against any volatility for a particular channel. Our extensive network of diverse financial institution partners gives us sufficient flexibility in terms of funding costs, geography coverage and pricing. Our full spectrum risk management capabilities allow us to target different user segments with effective pricing based on different market dynamics. Our access to some key financial license also gives our ecosystem great flexibility to comply with the ever changing regulatory environment.

Over the last 6 weeks or so, QFIN, along with other Chinese ADRs, has experienced extreme volatility in the market. While there are multiple risk factors trigger such share price movement, we believe the market is overreacting to the negative elements and ignoring the solid fundamental and strong growth prospect of QFIN.

As such, after careful evaluation, with the approval of our Board, management decided to launch a share buyback program. The company intends to repurchase up to USD 200 million of its ADS through open market or other form of transaction over the course of next 12 months. We believe at current market condition, share repurchase offers extremely attractive opportunity to deploy our cash and to generate great returns to our shareholders.

We continued to make progress in multiple strategy initiatives and gradually unlocked tremendous growth opportunities. We made significant progress on diversified user acquisition strategy. Customer base continued to grow, and customers' quality improved steadily. Our embedded finance model grew significantly. The number of new borrowers in Q2 hit the highest level in the past 6 quarters, up by more than 10% sequentially. The number of SME borrowers acquired offline also increased significantly. Our embedded finance model contributed close to 40%, 4-0 percent, of our new customers with approved credit lines in Q2. So far, we have established cooperation with 22 leading traffic platforms with another 8 in the pipeline.

Our SME finance business also achieved a breakthrough performance in Q2. By strengthening our ties with the leading industry partners and optimizing credit approval process and the policies, total amount of new approved credit line increased 22% Q-on-Q to RMB 7.1 billion, and outstanding loan balance increased 45% sequentially, with average ticket size exceeding RMB 250,000. Meanwhile, we are rolling out customized loan products catering to the specific funding needs of different industries.

In July, we launched tobacco business loan and have served more than 700 offline tobacco business owners. In the second half of this year, we plan to launch other industry-specific loan products targeting cross-border e-commerce, supply chain finance as well as agriculture and forestry sectors.

Loan facilitation under the capital-light model accounted for roughly 56% of total volume in Q2. And for the month of July, capital-light accounted nearly 60%, 6-0 percent, almost reached our full year goal for tech upgrading strategy.

For our smart marketing product, ICE, Intelligence Credit Engine, the number of active users increased 74% Q-on-Q. The transaction volume and outstanding balance both went up by 36%.

As for the recent regulatory change, we want to share a few thoughts here. As one of the 13 leading Internet platform on the April 29 regulatory meeting, we have maintained regular and close communication with regulators. Currently, the self-assessment and the related rectification process are moving forward in an orderly manner. We fully understand the regulators' requirements and expectation for the industry. Overall, our business is relatively focused and has a clear path towards full compliance with regulatory requirements.

We don't have online payments, online insurance or online brokerage operation, which are subject to more restrictive regulations. For our loan facilitation business, we don't do joint lending nor have overleveraged ABS issuance. Thus, we are highly confident to satisfy all of the revised regulatory requirements when everything is said and done.

As you may already know, the proposed new regulation will not allow loan facilitation platforms to provide credit assessment-related data directly to financial institutions. And such data transfer must go through a licensed credit agency. We have preemptively communicated with the regulators to understand the policy direction and to make necessary preparations. We will take multiple actions to satisfy this new regulation. On one hand, we can cooperate with existing third-party credit agency. On the other hand, we can also seek partners to jointly launch a new credit agency.

Recently, some media reports indicate that regulator will require consumer finance companies to implement an all-in interest rate cap of 24% for consumer lending. This is consistent with the regulators' long-term agenda to support real economy by lowering financing costs for consumers and SMEs. This is also consistent with our long-term business planning. Our on-balance sheet loan and SME loan business already priced below 24%. For our consumer facilitation business, even under a more restrictive stress test in which we assume to cut our price to below 24% rather rapidly, we do not expect the price cut to have a meaningful impact to our operational and financial results in 2021.

As for 2022, it will be a transitional year when the entire industry will comply with the 24% rate cap by June ending. In our stress test, we continue to see healthy volume growth in 2022, and net take rate should be around 3%. There are also some positive factors that may mitigate negative impact from the 24% rate cap. With lower price, we should be able to develop a partnership with larger national banks that typically offer more stable funding at lower funding costs.

In addition, with all of our asset at 24% or lower, we should be able to significantly increase the issuance of ABS, which typically carries a much lower funding cost around 5% to 5.5% versus around 7% from banks. Furthermore, at lower prices, we can attract more high-quality borrowers, which will naturally drive down overall credit cost by 1% to 2% points on IRR basis. Finally, based on our experience, lower pricing normally boosts the borrower activities, retention rate and lifetime value, LTV.

To conclude, we believe more prime customer and better quality financial institution would come along with lower-priced products. This will ultimately enhance our operational efficiency and make our business more resilient and sustainable. Such change may set up a solid base for us to accelerate growth after 2022. We feel quite optimistic.

I would now like to address the temporary removal of our 360 Jietiao app from App Store. The removal was due to our product engineer missed out one of the functions that was required by the regulators. We have already fixed the issue and our app has been restored to all major App Stores to date. We have conducted a thorough internal review and improved our operating protocol to ensure such incident will never happen again. Thanks to our diversified customer acquisition channel and the balance of product mix, the impact from app removal to our operation has been minimal.

During the quarter, we continued to diversify our funding source. We accelerated the pace of ABS issuance with a total of RMB 2.1 billion ABS in Q2 at an average coupon rate of 5.3%. This has brought our total ABS issuance to RMB 3.1 billion so far this year, ranking us #4 in the market. As our risk management systems support more business lines, we continue to see further enhance of our asset quality. The 90-day plus delinquency ratio across our platform was 1.19%. The M1 collection rate remained stable at 90.8% and day 1 delinquency rate at 5%.

We continue to expand the scale of our collaboration with KCB. Total accumulated loan facilitation volume as of Q2 was RMB 33.5 billion. Outstanding balance was RMB 20.4 billion at the end of Q2, up 60%, 6-0 percent, from Q1. We expect the scale of the KCB partnership to remain relatively stable for the time being. We have deep-rooted trust and great flexibility in our collaboration with KCB. Going forward, we will proactively explore new products and business opportunities through our cooperation with KCB.

We made some good progress on the ESG front, which drew more and more attention. When deadly flood hit Henan province this July, we took swift action to support by donating RMB 20 million through the 360 Foundation. Meanwhile, we organized a local team to join the rescue efforts.

Overall, we are quite satisfied with our performance in the first half of 2021. This fruitful result comes from dedicated efforts of our excellent team. I would like to express my gratitude to their hard work. We are in a time of rapid changes and great companies are always born in great changes. We have successfully demonstrated our capabilities and ambition over the past 5 years. Fintech is a vast market with huge potential, and fintech products have profoundly changed financial service landscape and the user experience. We will continuously launch innovative products and are dedicated to become the premium player in this market.

Now let me turn to our CFO, Alex, to run through more detailed info. Thank you.

Zuoli Xu ***360 DigiTech, Inc. - CFO & Director***

Thank you, Haisheng. Good morning, and good evening, everyone. Welcome to our quarterly earnings call. For the interest of time, I will not go over all the financial line items on the call. Please refer to our earnings release for the details.

As Haisheng mentioned, we delivered robust operating and financial results for the first half of 2021, powered by strong consumer demand for credit and further improvement in asset quality. The strong business momentum appears continuing into current quarter. In fact, we have seen record-breaking volumes in recent months despite some reported softness of macroeconomic activities lately.

Total net revenue for Q2 was CNY 4 billion versus CNY 3.6 billion in Q1 and CNY 3.34 billion a year ago. Revenue from credit-driven service, capital heavy, was CNY 2.4 billion compared to CNY 2.45 billion in Q1 and CNY 3.08 billion a year ago. The year-over-year decline was mainly due to facilitation volume mix change as capital-heavy contribution decreased significantly.

Revenue from platform service, capital light, was RMB 1.6 billion compared to RMB 1.15 billion in Q1 and RMB 259 million a year ago. The robust growth was mainly driven by exceptional progress we have made in capital light and other technology solutions. During the quarter, capital light and other technology solutions contributed roughly 56% of total loan volume, while the underlying take rate were relatively stable. We expect capital-light contribution percentage to continue to increase in the second half and to reach roughly 2/3 our total volume by the year-end.

During the quarter, average pricing was 27.2% compared to 26.6% in Q1 and 27.2% a year ago. Assuming the reported 24% rate cap guideline will be implemented across the industry, we are expecting overall pricing to gradually trending down through mid-2022 to satisfy the rate cap requirements. In our stress test, even under the more restrictive and steep rate cut scenario where we assume we cut the rate to below 24% starting from September 1, in this scenario, we should still be able to maintain healthy growth and profitability in the transitional year of 2022 and resume to a more robust growth afterwards.

As macroeconomic activities picked up in China in the first half, demand for Internet traffic also increased significantly along the way. In addition, we also proactively accelerated the pace of customer acquisition in recent -- in the last couple of quarters to take advantage of the overall positive business trend. As such, we have experienced some uptick in sales and marketing expenses.

Average customer acquisition cost on the consumer lending side for the quarter was about RMB 237 compared to RMB 206 in Q1. As we discussed in the past, average cost per proved credit line is a calculated number with limited value in our decision-making. We will continue to use life cycle ROI and LTV as key metrics to determine the pace and scope of our customer acquisition strategy. So far in 2021, healthy ROI trend has encouraged us to take a more proactive approach to accelerate the growth of our customer base.

Non-GAAP net income was RMB 1.61 billion in Q2 versus RMB 1.41 billion in Q1 and RMB 942 million a year ago. We once again set a new record in quarterly profitability driven by higher facilitation volume and noticeable improvement in asset quality.

Effective tax rate was approximately 18% for the first half of 2021. We see a similar level of ETR for the rest of the year. Longer term, we are expecting our normalized ETR to return to approximately 15%.

As we move towards a more technology-driven business model, we continue to see marked improvement in operating margins as increasing contribution from capital light and other technology solutions will generally lead to higher margin structure. Overall, we expect profitability growth to more or less keep pace with the facilitation volume growth throughout this year.

With strong operating results and increased contribution from capital-light model in Q2, our leverage ratio, which is defined as risk-bearing loan balance divided by shareholders' equity, further declined to 4.8x from 5.4x in Q1 and 8.3x a year ago. We expect to see continued deleveraging in our business driven by further movement toward capital light and solid operating results.

Total cash and cash equivalents was RMB 8.8 billion in Q2 compared to RMB 9.2 billion in Q1. Nonrestricted cash was approximately RMB 5.2 billion in Q2 versus RMB 6 billion in Q1. The modest decline in cash was mainly due to more proactive deployment of cash in our operations to support ABS and pre-ABS assets, which generates higher returns. Meanwhile, a significant portion of our cash was also allocated to secure deposit with our institutional partners and registered capitals of different entities to support our daily operation.

As we continue to generate strong cash flows through our operations, we believe our current cash position is more than sufficient to support the expansion of our business to invest in key technologies and to satisfy potential regulatory requirements. Therefore, we believe it is a prudent decision to use some of our "free cash" to invest in our own stock, which is priced just around the company's liquidation value. For a company that is still generating healthy growth for the next few years, we believe it is a great bargain.

Finally, let me give you some update about our outlook for 2021. The operating results for the first half of 2021 were very encouraging, and the momentum doesn't slow so far in the current quarter. Although we intend to keep our traditional conservative approach in providing forward guidance, the numbers start to speak for themselves. As such, we would like to raise our 2021 total loan volume guidance to between RMB 340 billion and RMB 350 billion compared to previous guidance of RMB 310 billion and RMB 330 billion. The revised guidance represents year-over-year growth of 38% to 42%. As always, this forecast reflects the company's current and preliminary view, which is subject to material changes.

With that, I would like to conclude our prepared remarks. Operator, we can now take some questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question is from Richard at Morgan Stanley.

Ran Xu *Morgan Stanley, Research Division - MD*

(foreign language) Basically, 2 questions from me. One is on the basically sending borrower information through the credit scoring agencies. Any detailed discussion on the actual process? Because it's been a little while. And you mentioned, basically, there has been further discussion. And there's different versions out there. I just want to see what is the latest development on that front.

Secondly is, obviously, very good loan volume. Any discussion with the regulators in terms of any views, any window guidance on the pace -- at the proper pace?

Haisheng Wu *360 DigiTech, Inc. - CEO & Director*

[Interpreted] Okay. So for the draft version of regulation on the administration of credit assessment business was announced, and we have been communicating with regulators for a long time, that actually, in the market, that there is no standard solution available so far as now.

And also, as Mr. Zheng has mentioned, that actually, there are 2 or 3 solutions we care about. The first one is that we apply for credit license to launch a new credit agency. And the second one is we cooperate with existing credit agency to continue our business.

Also, with our in-depth cooperation with KCB, which offers us another alternative for this solution. Whatever solution we adopt in the end, the process of product might be different. However, it will not affect our results of the risk management and our risk models.

So for your second question regarding to our growth rate, actually, we have seen that the growth is not the problem. And the regulators focus more on the standardization of the product and our business. Also, we have seen that in the requirement by the regulators, they have issued that they want the platforms, Internet platforms to sustain the growth and support real economy continuously.

Operator

Our next question is from Alex Ye at UBS.

Xiaoxiong Ye *UBS Investment Bank, Research Division - China Financials Research Associate*

(foreign language) I will briefly translate my question. First one is on the regulatory development. So it looks like the current direction from the regulators continues to tighten the various aspects of the data collection by the Internet companies. So I'm wondering if the regulators' issue more stringent regulation on consumer data collection and yields in the future, how would that affect our current practice of data collection and use? And how would that affect our credit model?

Second question is on your plan toward complying with the 24% interest rate cap. So you mentioned that in your stress test, you're going to comply -- fully comply with the 24% cap by September this year. But -- so if that is the stress test, then what's your base case or your target trajectory toward complying with that new cap?

And then the third question is also related to the interest rate trend. So the market concerns about the 24% cap is only just the beginning of the future regulatory requirement of further pushing down the overall lending rates. So I'm wondering if you have any comment on that. And specifically, given you're also ramping up your SME loans, so it looks like this segment will be subject to further pressure from lower rate, no guidance. Also would appreciate your comments.

Haisheng Wu ***360 DigiTech, Inc. - CEO & Director***

[Interpreted] Okay. Thank you, Alex for your question. So regarding your first one, that we actually will see tightening as well about the data capture and usage in this industry. So for regulatory side, we think there are 2 basic principles. The first one is the minimum standard for data capture. So apart from capturing data from customer side, like for customer forms or application, we are working proactively with third-party credit agency for industry and external data sources as well as replacement. And the second principle is that the customer authorization is mandatory before data capture. As you may know, that our removal of our 360 Jietiao application from App Stores was caused by these problems. So we will emphasize more on this principle in the future. We believe that with our relatively standard process and the impact of these tightening principles will have minimal impact on our business.

Regarding your second question, the time line of the all-in interest rate cap at 24%, actually, we say that there are different time lines for different institutions. Some institutions will follow the guideline that the outstanding balance of the loan, over 24% will be reduced to 0 by end of June next year. And some institutions follow the guidelines that there will be no new originations by June next year. So we will follow this accordingly.

Regarding your third question that if the 24% interest cap will be lowered more, actually, as all market participants know, 24% interest cap has been the window guidance from regulators to banks for a long time. Recently, media reports speculate that base interest cap requirement extends to consumer finance companies. Since the 24% cap has existed in the industry for quite some time, we don't think the rate cap will further go down. Thank you for your question.

And furthermore, regarding the interest rate of SME loans, of course, regulators want to see the interest rate to be as low as possible, but there is no standard. It's similar to the consumer finance industry, there are different and various needs and supplies of the SME loans. As a platform, as an intermediary, we will continue to offer the various services to meet different kinds of needs of the SME loans. Thank you.

Operator

Our next question is from Jacky Zuo at China Renaissance.

Jacky Zuo ***China Renaissance Securities (Hong Kong) Limited, Research Division - Analyst***

(foreign language) So let me translate. So congrats for the strong results. My first question is related to regulation as well. So for the 24% interest rate cap, management gave a stress test for next year regarding the margin, probably will go down to 3%. So I just want to understand what is our assumptions behind the stress test regarding to APR funding costs and credit costs and other expenses. And any chance we can give an outlook for APR in the third quarter?

And second question is regarding to the SME loan. We've seen other competitors also moved to this new business. So how are we going to differentiate our SME loan products? And what is the APR margin and our growth target this year? And is this SME loan included in our new loan volume guidance?

Haisheng Wu ***360 DigiTech, Inc. - CEO & Director***

[Interpreted] Thank you, Jacky. Regarding to your first question about the stress test, actually, what we have delivered now is a relatively static test with all other factors' status quo, especially there's no improvement in our efficiency. So we estimate there is no cost changes in this version of the stress test. However, as we have known that there is still improvement of our cost.

For example, for our funding cost, before we have a large portion of our funding from consumer finance components with a relatively higher funding cost, and our ABS volume is also limited. However, with a lowering cap interest rate, we can have more funding from national banks or larger national banks, and we can increase our ABS volume. So we expect our funding cost to be lowered by 1%. And we have the credit loss expectation to be lowered by around 1% as well. For another major cost, the customer acquisition cost will be lower as well. So we expect that actually, the take rate of 3% will be improved in the future.

For the third quarter of this year, we have started the lower APR test. So the APR will be lowered, but there will be no meaningful impact on our financial results of the next quarter.

So for your second question regarding to our competitiveness of SME loans, so there are 2 aspects. The first one is about risk management. Our SME business is different from the traditional ones because we focus more on the SME side. Considering the traditional SME loans are over 10 million ticket size, it's not fully data-driven. However, we have adopted a dual engine regarding to our risk management about SME loans. That is a way to evaluate from the individual side and from the corporate side. With ticket size of 250,000 on average, we have used and fully utilized our accumulated experience on risk management in the past years on consumer finance.

And the second advantage of us is the cooperation with KCB. As the only 3 platforms in China market that are able to have in-depth cooperation with banks, we believe we have the advantage of data and funding costs regarding to the SME business.

So for our target of SME loans this year, it will account for around 10% to 15% of our total loan origination, and it has been covered in our guidance.

Zuoli Xu ***360 DigiTech, Inc. - CFO & Director***

Okay. Jacky, just -- I have a few sort of clarification and add up to Mr. Wu's comments there. Number one, the most important clarification, that 3% is not a margin. It's the take rate, right? Our net margin this quarter was 40%. And if anything, for the next couple of quarters, we'll probably see a little bit expansion of net margin than this Q2. So the 3%, though is the take rate on loan balance that we have been saying this in the past.

And then secondly, also regarding the second half pricing trend. Even though our stress test was taken a more drastic cut starting from September 1, basically on that day, everything goes below 24%. But in reality, that's not going to be the case. Just like Haisheng mentioned, it's really dependent on the pace of our financial institution partners, their kind of progress there. So most likely, it will be a gradual trending down toward that kind of goal by the end of June of next year.

So if you do a linear kind of distribution on any given quarter from now to the mid of next year, you're probably looking at maybe 1 percentage or a little bit over 1 percentage point change in pricing, if you just average out. So that's regarding the pricing change.

And then this kind of a change for 2021 -- for the remainder of 2021, we don't see any kind of a meaningful impact in both loan volume or the take rate. That's why in my prepared remarks, I mentioned that the second half profitability will most likely keep in pace with the loan volume growth. You have our guidance for the full year, you can do the calculation -- roughly get the profitability number for the second half, okay? So that's another clarification.

Then the third point is really about how do we get that 3% take rate when this whole thing is said and done. I have a kind of a back-of-an-envelope calculation. Let's assume in our current mix in terms of cap light versus cap heavy at 60 versus 40, 60 being the cap light, and normally, the reality is, our cap-light side of business carry a higher pricing versus the cap heavy. So if we, let's say, cut all the pricing to 22.5%, then on the cap-heavy side, we need to cut roughly about 2%. On the cap-light side, we need to cut roughly about 6.5% to 7%.

But keep in mind that 6.5% to 7% cut is actually the overall cut. Remember, we are only taking 30% of that sharing. So 6% to 7% cut to us is only 2% in real impact, right? So essentially, the cap light and cap heavy, basically, you have a similar 2% impact just by the pricing alone. That's a pretax impact. If you add the tax rate on it, the net impact on the pricing alone will probably be somewhere around 1.7%, 1.8%, maybe. Okay. So that's a pricing loan.

And then forget about the funding cost savings, the operational efficiency and all these other things. The one clear change will be the risk factor, just simply because when the pricing coming down, you are naturally targeting a high-quality group of users. Okay. For that, by our estimate, the savings from, after-tax savings from that sort of credit cut side will be coming somewhere around 0.6% to 0.8% range. So if you deduct the pricing impact, 1.7% deduct 0.6% to 0.8% from the 1.7% to 1.8%, you get roughly 1%. That's not even considering anything on the funding cost, on operational efficiency and all the other things Haisheng mentioned earlier. So that's the very rough calculation just for your reference.

Operator

That's the end of the Q&A session. I would like to hand it back to management for brief closing remarks.

Zuoli Xu ***360 DigiTech, Inc. - CFO & Director***

Okay. Thank you, everyone, again, to join our conference call. And if you have any additional questions, please feel free to contact us. Thank you.

Haisheng Wu ***360 DigiTech, Inc. - CEO & Director***

Thank you.

Zuoli Xu ***360 DigiTech, Inc. - CFO & Director***

Operator, can we hang up?

Operator

Yes. That's the end of the conference call. You can hang up. Thank you.

[Portions of this transcript that are marked [Interpreted] were spoken by an interpreter present on the live call.]