PPDAI Group Inc. [PPDF]
Q4 2017 Earnings Conference Call
Wednesday, March 21, 2018, 8:00 AM EST

Company Participants
Jimmy Tan, Investor Relations Director
Cliff Jun Zhang, Chairman and Chief Executive Officer
Simon Ho, Chief Financial Officer
Feng Zhang, Chief Operating Officer

Analysts
Alice Li, Credit Suisse
Daphne Poon, Citigroup Hong Kong

Presentation

Jimmy Tan: Welcome to Paipaidai's fourth quarter and fiscal year 2017 earnings conference call. The Company's results were issued via newswire services earlier today and are posted online. You can download the earnings release and sign up for the Company's distribution list by visiting the IR section of our website at: ir.ppdai.com.

Mr. Cliff Zhang, our Chairman and Chief Executive Officer, and Mr. Simon Ho, our Chief Financial Officer, will start the call with their prepared remarks. Mr. Feng Zhang, our Chief Operating Officer, will join the call during the Q&A session.

During this call, we will be referring to several non-GAAP financial measures to review and assess our operating performance. These non-GAAP financial measures are not intended to be considered in isolation or as a substitute for the financial information prepared and presented in accordance with U.S. GAAP. For information about these non-GAAP measures and reconciliation to the GAAP measures, please refer to our earnings press release.

Before we continue, please note that today's discussion will contain forward-looking statements made under the safe harbor provisions of the U.S. Private Securities Litigation Reform Act of 1995. Forward-looking statements involve inherent risks and uncertainties. As such, the Company's results may be materially different from the views expressed today.

Further information regarding these and other risks and uncertainties is included in the Company's filings with the U.S. Securities and Exchange Commission. The Company does not assume any obligation to update any forward-looking statements except as required under applicable law.

Finally, we posted a slide presentation on our website providing details on our results for the quarter.

I will now turn the call over to our CEO, Mr. Cliff. Please go ahead, sir.

Cliff Zhang: Hello, everyone, and thank you for joining our earnings conference call today. 2017 was a special year for us as it marked our 10^{th} anniversary since inception and represented a significant milestone in our journey.

We are pleased to continue delivering significant growth in both financial and operational results in this very special year and maintain our position as the leading online consumer finance marketplace in China.

For 2017, we achieved an increase of 222% in operating revenue from 2016, driven by a 230% growth in our loan origination volume to reach a record high of RMB65.6 billion, thanks to our rapidly expanding user base.

As of December 31, 2017, Paipaidai had 65.4 million registered users, and has reached 10.5 million cumulative borrowers, compared to 32.6 million registered users and 3.8 million cumulative borrowers 1 year ago. At the same time, our cumulative investor base increased to approximately 560,000, a 57% increase from the prior year.

Our large and loyal investor base enables us to maintain our competitive advantage, as it provides a stable and a sustainable source of funds for our operations. We will continue to adjust and evolve our products and services to better serve our customers through our highly scalable marketplace model.

With new regulations gradually unveiled and enforced in the back half of 2017, the overall online consumer lending market has been under tighter government scrutiny, and PPDAI was no exception. To comply with recently issued regulatory changes, we have made some adjustments to our operations that have only minor impact to our operations. Our core business model remains unchanged.

We are confident to satisfy any further requirements if needed, and we currently expect to complete the peer-to-peer lending registration process by the second quarter of 2018.

We believe that the strengthened regulatory framework is a big step forward and will support a healthy and sustainable industry environment. As an industry leader with the longest operating history in the sector, and strong proprietary technologies and core capabilities, we are well positioned for future growth.

As disclosed earlier in the year, we have partnered with Sino Guarantee to launch a new quality assurance program to further advance our compliance with the evolving online lending regulatory requirements. The rules for this new program are substantially the same as the previous quality assurance programs run by Paipaidai.

Looking ahead in 2018 and beyond, technology innovation, with a keen focus on creating a superior user experience, remains the cornerstone of our business model. As such, we will underscore our technology innovation through multiple initiatives. For example, by exploring advanced technologies, such as artificial intelligence, big data analytics, cloud computing and blockchain technology, we strive to enhance the accuracy, efficiency and effectiveness of our smart finance platform.

As a pioneer and industry leader, we will continue to fulfill our mission to utilize the most innovative technologies to deliver highly accessible and convenient financial services solutions while achieving our long-term business goals for the benefit of all stakeholders.

In particular, I am pleased to announce that our board of directors has approved a share repurchase program which authorized the Company to repurchase an aggregated value of up to US$60 million during the next 12-month period. We strongly believe that our share price has been deeply undervalued and this US$60 million buyback clearly demonstrates our confidence in our growth prospect and our commitment to maximize shareholder value.

With that, I will now turn the call over to our CFO, Simon Ho, who will discuss our financial results and an update of our business.

Simon Ho: Thank you, Cliff, and hello, everyone. In the light of the regulatory changes impacting our industry, coupled with a broad-based weakening credit trend, we are delighted to deliver strong operational results in the fourth quarter, as reflected by an increase of 134% in loan origination volume to RMB17.6 billion from RMB7.5 billion in the same period of 2016. This solid growth is supported by the huge market opportunities for online consumer finance and the rapid growth in our user base.

Our Non-GAAP adjusted operating revenues for the fourth quarter, excluding a one-time provision for expected discretionary payments to investors in investment programs protected by the company's investor reserve fund, was RMB1.02 billion, representing a year-over-year increase of 107%.

Despite our strong growth trajectory on a year-over-year basis, we recorded a soft sequential performance in the fourth quarter in terms of loan origination volume and loan facilitation fees. As outlined previously, the growth of our loan origination volume and loan facilitation fees was primarily impacted by our proactive efforts in controlling our loan volume due to increased delinquencies associated with increased credit risk across the industry. Additionally, the elimination of the collection of upfront transaction fees also had a one-off impact in December, as we now receive fees over the first several months of the loan.

That being said, and as discussed in detail during our last call, a new U.S. GAAP revenue recognition standard has taken effect in 2018, which requires us to recognize revenues from such transactions upfront. This means the December impact was a one-off event, and we are confident that the changes in the transaction fee model will not impact our revenue level going forward.

Before I go into the financial details, let me summarize a few key points related to the losses in our risk reserve funds in the fourth quarter.

First, in the fourth quarter, we experienced a sudden increase in credit risk like the rest of the market, and as a result, we increased our expected default rate assumptions, which resulted in sizeable charges.

Second, these charges were more pronounced for our investor reserve funds due to the use of mark-to-market accounting, which is much more sensitive to changes in the expected default rate.

Third, the one-time charges are largely non-cash for the fourth quarter, and we believe most of these losses are behind us. In our view, the current credit cycle has peaked, and delinquencies are unlikely to negatively surprise us going forward.

Lastly, all of our previously recognized gains from the investor reserve funds have been effectively reversed out by the end of 2017, and we do not expect further material gains or losses going forward from our investor reserve funds.

As a gentle reminder, we mentioned on our last call that we have discontinued our Investor Reserve Funds on January 1, 2018, and the existing funds are in run-off mode.

I will go into more details about the Investor Reserve Funds a bit later, but first, let me walk you through our detailed financial results for the fourth quarter.

As we have mentioned, the 85% year-over-year increase in operating revenues for the fourth quarter was primarily due to the increase in loan facilitation service fees, post-facilitation service fees and other revenues as a result of the substantial increase in loan origination volume. This was offset by a one-time provision of RMB108 million to cover the estimated shortfall for what investors expect to receive from their investment programs. This was due to the increase in delinquency rates.

Loan facilitation service fees increased by 98% to RMB620 million for the fourth quarter, primarily due to the substantial increase in loan origination volume and the number of unique borrowers on our platform. During the fourth quarter, loan facilitation fees were negatively impacted by around RMB140 million to RMB180 million due to the discontinuation of collecting upfront transaction fees.

The underlying average transaction fee rate charged to borrowers was little changed, and was 6.24% in the fourth quarter of 2017, compared to 6.35% in the third quarter of 2017.

Post-facilitation service fees increased by 181% year-on-year to RMB227 million for the fourth quarter of 2017, primarily due to the substantial increase in loan origination volume and the rolling impact of deferred transaction fees.

Other revenue increased by 75% year-over-year to RMB172 million for the fourth quarter of 2017, primarily attributable to an increase in loan collection fees.

Net interest income and loan provision losses for the fourth quarter of 2017 was an expense of RMB13 million, compared with an income of RMB3.6 million in the same quarter of 2016. This was primarily due to provisions for expected loan losses related to the trusts that were newly set up during the period.

Origination and servicing expenses increased by 154% year-over-year to RMB296 million for the fourth quarter of 2017, primarily due to the increase in headcount particularly for consumption loan products and loan collection services, and to a lesser extent, due to an increase in referral fees paid to third parties for successful loan originations.

Sales and marketing expenses increased by 87% year-over-year to RMB239 million for the fourth quarter of 2017. The increase was primarily due to an increase in expenses associated with online customer acquisition, which mainly included expenses paid to internet marketing channels for online advertising and branding, search engine marketing and also to certain popular websites which enable us to reach quality borrowers.

General and administrative expenses increased by 183% year-over-year to RMB250 million for the fourth quarter of 2017, primarily due to the increase in staff costs and recognition of RMB106 million share-based compensation expenses in the quarter related to employee options granted historically with a performance target contingent upon IPO, and also, cancellation of the share-based compensation plan of a subsidiary company.

Our Non-GAAP adjusted operating income, which excludes share-based compensation expenses and a one-time expected discretionary payment to investors in investment programs protected by the Company's Investor Reserve Fund in the fourth quarter, increased by 100% to RMB327 million from RMB163 million in the same period last year.

Other income or expenses recorded an expense of RMB695 million for the fourth quarter 2017, compared to income of RMB125 million in the same quarter of 2016. Other income primarily consisted of a RMB27 million realized gain from financial guarantee derivatives due to the amount of investment programs maturing during the period.

However, the gains were offset by a RMB272 million largely non-cash expense related to the quality assurance fund, and a RMB460 million non-cash expense related to a fair value change of financial guarantee derivatives due to increased credit risks across the industry. This led to upward adjustments in our expected default rates for loans protected by the quality assurance fund and the underlying loans in investment programs protected by the Investor Reserve Funds.

As previously mentioned, the losses related to the Investor Reserve Funds are larger than the quality assurance fund due to the use of mark-to-market accounting which makes the IRF much more sensitive to changes in the expected default rate. When the expected default rate is revised upwards, we have to reverse out previously recognized gains. The RMB460 million negative fair value change reflects the full reversal of all cumulative gains recognized in the IRF program.

In summary, these are largely non-cash expenses in the fourth quarter. And we believe we've taken most of the losses off the table due to the reasons discussed earlier, i.e., the peak of the current credit cycle having been reached, making it unlikely to be surprised by delinquencies going forward and the full reversal we made of our previously recognized gains from the IRF.

One quick note before we move on -- as of March 12, we have ceased to offer new investment programs with step-up returns to investors due to compliance requirements. All existing holders of this type of investment program will not be affected by the change, and we expect this change will not have a material impact on our results.

Moving on, income tax gains were RMB74 million for the fourth quarter of 2017, compared to an expense of RMB22 million in the same period of 2016, primarily due to the loss from the quality assurance fund and negative fair value change of financial guarantee derivatives during the period.

Because of the foregoing, net loss was RMB507 million for the fourth quarter of 2017, compared net income of RMB266 million in the same quarter of 2016.

Net loss attributable to ordinary shareholders of the Company was RMB1.3 billion for the fourth quarter compared to a net income of RMB18 million in the same quarter of 2016 due to the accretion losses on our Series A, B and C preferred shares.

Turning to our balance sheet, we have a solid balance sheet and ample liquidity. As of December 31, 2017, we had cash and cash equivalents of RMB1.89 billion, and short-term investments mainly in money market funds of RMB1.96 billion.

Our quality assurance fund remains well funded. The total balance of our quality assurance fund, which includes restricted cash of RMB1.06 billion and the quality assurance fund receivable of RMB1.15 billion, was equivalent to 17.9% of the total outstanding loans protected by the quality assurance fund.

To be mindful of the length of our earnings call, for the full year 2017 financial results, I'll encourage listeners to refer to our earnings press release for further details.

Now before we turn the call to questions, I'd like to close with a few comments on our business outlook.

As Cliff mentioned, we are on track to complete the registration process, and will continue to closely monitor industry trends to be agile in making adjustments when market cycles occur. Being through multiple economic cycles, we are ready and experienced to handle these changes.

China's consumer finance industry remains dynamic with enormous demand driven by the rapid transformation of the economy. As a technology-driven marketplace, we are well positioned to capitalize on the growing market under a healthier and less competitive environment.

In terms of guidance, we expect total loan volume for the fiscal year 2018 to be in the range of RMB70 billion to RMB80 billion, with a heavier weighting towards the back half of the year. This forecast is our current and preliminary view, which is subject to change.

With that, I will conclude my prepared remarks. We will now open the call to questions. Operator, please go ahead.

Questions and Answers

Operator: We will now begin the question-and-answer session. (Operator Instructions). For the benefit of all participants on today's call, if you wish to ask your question to management in Chinese, please immediately repeat your question in English.

The first question today comes from Alice Li, Credit Suisse.

Alice Li: I have two questions. First, there was a loss RMB700 million of losses from the risk reserve funds due to the higher credit risk. As many pass-ons could lift this industry after the registration, would you expect this to trigger another round of credit crunch and a similar loss this year? This is my first question.

And my second question is that as you discontinue the IRF operation, the credit level 1, 2, 3 loans are now unprotected. Would this affect investors' interest in these loans and make the loan mix skewed to the lower quality loan? Many thanks.

Feng Zhang: This is Feng Zhang; I'm the COO of the Company. I'll take the first question. So, we have observed a spike in delinquency for the overall portfolio, which is the (inaudible) that the industry has seen in the period -- in a very short period from the end of November to end of December. And starting from end of December, we've seen that peak gradually coming down, and right now, it has come back to the pre-increase level.

So to your question, we believe with all the registration rules being issued end of last year timeframe, the smaller, the weaker players have already ceased operating and have already quit the market. So we do not expect -- or we think it's already pretty much settled. I think the remaining large ones that are still operating in the lending space, will most likely continue to operate, but we do not expect another one and another trigger to spike in the risk during the registration process.

Simon Ho: Hi, this is Simon. I'll take the second question -- about your questions about the investors having no protection. We have so far not seen any material change in the behavior of our investors as a result of obviously the changes we've made. Just to highlight also, we have always historically had a proportion of loans in the platform that have no protection whatsoever, and we do have a segment of investors that like this type of investment and are used and experienced to doing this type of investment. So far, we have not seen any significant material change in the behavior of our investors.

Alice Li: Thanks very much, very helpful.

Operator: (Operator Instructions). Robert Zu, Citi Hong Kong.

Daphne Poon: Hi, actually it's Daphne Poon here from Citi. Thanks for taking my question. So I've got two questions. First is about the margin outlook. So we note that actually across the industry through the credit cycle (inaudible) has increased the long collection the reason why we saw the origination (inaudible). But on the other hand, the sales and marketing expand. I'm not sure as per credit industry consolidation there would be some room for our customer acquisition cost as share comes down. So just wondering on that basis, what is our margin outlook going forward?

Second is about the loss on the quality assurance fund and IRF, wondering what is our underlying assumption of the expected loss we have in the fourth quarter? And on the QAF side, are we looking at more, potentially more loss remaining in the first quarter? Thank you.

Simon Ho: Hi, Daphne. So let me just review some of the outlook. I think first of all, I could say that, for example, for our headcount outlook, we would expect some moderate growth in our headcount this year, mainly in loan collection, as you mentioned. In the long run, we will continue to invest in technology and this will enable us to compete effectively, and also, consolidate the market.

In terms of the customer acquisition cost trend and the outlook, we do believe the market is still evolving. After the credit cycle that we've been through, there are still some uncertainties. And although some of the smaller players have exited the industry, we wouldn’t totally underestimate the existing players either. So I think at the moment therefore, we would remain relatively cautious on acquisition costs, which could stay at relatively elevated levels for the rest of the year.

The average cost of a new borrower in the fourth quarter for us was between RMB120 and RMB130. That is compared to about an average of about RMB100 for the full year of 2017. The cost in the first few months of this year have risen further, partly because of the decline in our loan approval and conversion rates as a result of obviously, the slowdown and tightening of credit risk. So I hope that helps to give you some color on the outlook for the margins.

Now, in terms of the assumptions for our quality assurance fund, as we've said before, we have been -- we're expecting fourth quarter vintage-basis cumulative delinquencies to end up around in the high-single-digits. So roughly speaking, the level that the expected default rate assumptions we have used for the QAF and IRF will be in line with this experience. So I think that's still the case.

And your final question is about whether we will continue to have QAF losses, is that correct?

Daphne Poon: Yes.

Simon Ho: Right. In the first quarter, we anticipate actually that the QAF line may not be material in either way. I could also say that for new loan bookings we are making in 2018, the contributions into the QAF by the borrowers are higher than the expected default rates that we are using. And in fact, it could therefore be possible that there can be some moderate gains in the QAF so far this year.

Daphne Poon: Okay. Can I have a follow-up on -- so how much is our loan is currently covered by the QAF and how the percentage changes going forward?

Simon Ho: Sure. The percentage of total outstanding loans that are covered by the quality assurance fund at the end of 2017 was roughly about 50% of the total loan outstanding balance. This ratio is likely to increase moderately into 2018.

Daphne Poon: All right. Thank you.

The other side of that leg, I have to say, is because the IRF component has -- is declining, of course. That portfolio is in runoff mode.

Daphne Poon: (Inaudible).

Simon Ho: The percentage of QAF protection has been going up and if I give you another figure -- if you look at our total loan volume, in the fourth quarter, it says 60% of the loan volume, we originated in the fourth quarter had QAF protection. So the direction is up.

Daphne Poon: Okay, thank you.

Operator: (Operator Instructions). Since there appears to be no further questions, I would like to turn the conference back over to Paipaidai management for any closing remarks.

Simon Ho: Operator, perhaps we should give it a bit more time to see if there are any further questions.

Operator: There appears to be no questions at this time.

Jimmy Tan: Thank you once again for joining us today. If you have any further questions, please feel free to contact Paipaidai's investor relations through the contact information provided on our website or in our press release. Thank you.

Operator: This conference has now concluded. Thank you for attending today's presentation. You may now disconnect.