PPDF - PPDAI Group Inc.
First Quarter 2018 Earnings Conference Call
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Company Representatives:
Jimmy Tan; Investor Relations
Cliff Jun Zhang; Chairman and Chief Executive Officer
Simon Ho; Chief Financial Officer
Feng Zhang; Chief Operating Officer

Analysts:
Alice Li; Credit Suisse
Stephanie Poon; Citigroup Hong Kong
Sanjay Sakhrani; Keefe, Bruyette & Woods, Inc.
Robbie Li; Generation Capital
Matthew Larson; Wells Fargo

Presentation

Operator: Hello ladies and gentlemen. Thank you for standing by for the First Quarter 2018 Earnings Conference Call for PPDAI Group Inc., also known as "Paipaidai." [Operator Instructions] Today’s conference call is being recorded.

I will now turn the call over to Mr. Jimmy Tan, Investor Relations Director for the company. Jimmy, please go ahead.

Jimmy Tan: Hello, everyone, and welcome to Paipaidai’s first quarter 2018 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 Question-and-Answer 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 this non-GAAP measures and reconciliation to 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 IR website providing details on our results for the quarter.

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

Cliff Jun Zhang: Hello, everyone, and thank you for joining our earnings conference call today.

We are pleased to report a solid start to 2018 as we continue to utilize our over 10 years of experience to drive results and maintain regulatory compliance in an evolving consumer lending environment. As widely noted, and as we highlighted in March on our fourth quarter call, we experienced a rise in delinquencies late last year as the industry digested changes in the regulatory environment, and consumers adjusted to the new framework.

Despite those challenges, in the first quarter, our operating revenue grew 37% year-over-year, while non-GAAP operating income grew 48% versus the same period of 2017. In addition, the count of registered users and cumulative borrowers continues to grow.

The proactive steps we took to manage risk through this cycle impacted loan volume in the quarter. But despite slower volume growth, our efficiency gains helped us generate a solid increase in operating profitability in the quarter.

We believe the credit cycle bottomed earlier this year, and we started resuming loan origination growth in March, resulting in improving trends following the typical slowdown in activity during Chinese New Year. Encouragingly, market demand remains strong, and we saw those improving trends continue into April and early May. Our performance in the quarter is a testament to the resilience of our core business model, the strength of our established brand and the deep industry knowledge of our team.

While we are gradually resuming loan origination growth, we are also investing in new engines of growth through the monetization of our core competencies and competitive advantages. As just one example, we see an opportunity to capitalize on our technological capabilities, massive amounts of data and accumulated expertise garnered throughout our 11-year operating history to provide a suite of cutting-edge "technologies as a service" to third-party financial service providers.

Those services include online customer acquisition, fraud detection and loan collection tools. We hope to share more on these new engines of growth on future calls.

As an industry leader with the longest operating history in the sector, we are focused on capitalizing on the tremendous growth opportunities we see, both in our core business and through logical extensions, as the industry continues to evolve. We are well positioned to react to any future regulatory changes while monitoring and mitigating the risks associated with the credit cycle.

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.

Our results in the quarter reflect our proactive efforts to manage our loan book risk through the industry-wide credit down cycle that began late last year. Loan origination growth slowed year-over-year and was down sequentially from the fourth quarter as we tightened standards in response to rising delinquencies.

Despite the slower growth, we continued to drive operating profitability through control of sales and marketing expenses and operational improvements designed to enhance operating margin. In particular, we are leveraging AI technologies to improve operating efficiency through the deployment of chatbots in customer service and loan collections. Currently, about 40% of our total customer enquiries and our loan collection efforts on early delinquencies are being handled by bots.

Also in the first quarter, we experienced more repeat users, which are more profitable than new borrowers. Combined, these factors allowed us to achieve a healthy non-GAAP operating margin of 44% in the quarter.

We are executing well and our business model remains strong after adjusting to the new regulatory framework. As we work to restore growth, we are well positioned to capitalize on opportunities provided by a large and growing industry in a healthier and less competitive environment.

Now let me walk you through our detailed financial results for the first quarter. But before I start, I'd like to remind you we adopted the new revenue recognition policy, ASC 606, effective January 1, 2018, and as a result, we recognized an increase of approximately RMB176 million to the opening balances of retained earnings, and an increase of approximately RMB170 million in operating revenues for the first quarter 2018.

These adjustments were mainly due to the timing of revenue recognition for transaction fees collected in monthly installments. As you may recall, we changed our transaction fee collection in December 2017 from upfront to monthly installments, and the new ASC 606 revenue standard recognizes such revenues earlier than the previous standard. Under ASC 606, we have also allocated loan collection fees of RMB110 million in the first quarter of 2018 from other revenues to loan facilitation service fees and post-facilitation service fees. This is because the new standard considers certain loan collection fees as variable consideration related to loan facilitation and post-facilitation performance obligations.

Now I'll continue the discussion. Operating revenues for the first quarter of 2018 increased by 37% to RMB917 million from RMB669 million in the same period of 2017, primarily due to the increase in loan facilitation service fees, post-facilitation service fees and other revenues as a result of an increase in loan origination volume, and also the adoption of the new revenue recognition standard ASC 606 effective January 1, 2018.

Loan facilitation service fees increased by 23% to RMB621 million for the first quarter of 2018 from RMB505 million in the same period of 2017, primarily due to an increase in loan origination volume and the adoption of ASC 606. Related to the adoption of ASC 606, loan collection fees of RMB83 million have been allocated from other revenues to loan facilitation service fees. The average rate of transaction fees charged to borrowers increased slightly to 6.32% in the period, compared to 6.24% in the fourth quarter of 2017 and also 6.95% in the first quarter of 2017

Post-facilitation service fees increased significantly by 166% to RMB227 million for the first quarter of 2018 from RMB85 million in the same period of 2017, primarily due to the increase in loan origination volume and the rolling impact of deferred transaction fees, and also the adoption of ASC 606. Related to the adoption of ASC 606, loan collection fees of RMB27 million have been allocated from other revenue to post-facilitation service fees.

Other revenue decreased by 12% to RMB69 million for the first quarter of 2018 from RMB78 million in the same period of 2017, primarily attributable to the adoption of ASC 606, which, as mentioned just now, loan collection fees of RMB110 million have been allocated to loan facilitation and post-facilitation service fees. This impact was offset by an increase in management fees from investment programs that invest in loans protected by the quality assurance fund.

Net interest income and loan provisions losses for the first quarter of 2018 was an income of RMB27 million, compared to RMB0.5 million in the same period of 2017, mainly due to the increase in trusts set up in 2017 for the purpose of serving institutional investors. Origination and servicing expenses increased by 43% to RMB247 million for the first quarter of 2018 from RMB173 million in the same period of 2017, primarily due to the increase in headcount-related costs.

Sales and marketing expenses increased by 10% to RMB151 million for the first quarter of 2018 from RMB137 million in the same period of 2017. The increase was primarily due to the increase in expenses associated with online customer acquisition, which mainly include expenses paid to internet marketing channels for online advertising and search engine marketing, as well as to certain websites that enable PPDAI to reach quality borrowers and enhance branding.

General and administrative expenses increased by 89% to RMB146 million for the first quarter of 2018 from RMB77 million in the same period of 2017, primarily due to the increase in staff costs. G&A expenses for the period also included share-based compensation of approximately RMB15 million.

Operating income increased by 42% to RMB400 million for the first quarter of 2018 from RMB281 million in the same period of 2017.

Non-GAAP adjusted operating income, which excludes share-based compensation expenses, was RMB415 million, representing an increase of 48% from RMB281 million in the same period of 2017.

Other income was RMB132 million for the first quarter of 2018, compared with RMB209 million in the same period of 2017. Other income primarily consisted of a gain of RMB60 million related to the quality assurance fund due to the increase in loans facilitated on our platform that are protected by the quality assurance fund, and a gain of RMB72 million from a fair value change of financial guarantee derivatives, offset by a RMB45 million realized loss from financial guarantee derivatives due to the amount of investment programs maturing during the period. Note that the company reevaluates the fair value of outstanding guarantee derivatives at each balance sheet date to reflect market participant's view on the expected default rate based on the latest market changes. Income tax expenses was RMB95 million for the first quarter of 2018, compared with RMB74 million in the same period of 2017.

Because of the forgoing, net profit increased by 5% to RMB438 million for the first quarter of 2018 from RMB417 million in the same period of 2017. Net profit attributable to ordinary shareholders of the company was RMB439 million for the first quarter of 2018, compared with net loss attributable to ordinary shareholders of RMB285 million in the same period of 2017 due to the accretion losses on the company's Series A, B and C preferred shares in the first quarter of 2017.

Turning to our balance sheet. We maintained a solid balance sheet and ample liquidity. As of March 31, 2018, the company had cash and cash equivalents of about RMB1.5 billion and short-term investments mainly in wealth management products of about RMB2.3 billion.

Our quality assurance fund remains well funded. The total balance of the quality assurance fund, which includes restricted cash of about RMB1.2 billion and the quality assurance fund receivable of about RMB1.3 billion, was equivalent to 19% of the total outstanding loans protected by the quality assurance fund.

We announced a $60 million share repurchase program in March, and since then we have repurchased approximately 0.5 million ADS's, for a total of $3.6 million.

Now before we turn the call to questions, I'd like to close with a few comments on our business outlook. Despite a somewhat slow start to the year in loan originations, we continue to expect to achieve our full year volume target range of RMB70 billion to RMB80 billion, with a heavier weighting towards the back half of the year. We have steadily been increasing our monthly loan volume and are encouraged by the results. Our outlook assumes we receive registration approval later this year, and we are in a good position to meet the necessary requirements.

However, timing is uncertain, and we recently became aware that central regulatory authorities have postponed P2P registrations. We are closely monitoring the situation and will provide updates as we receive them. In the meantime, as I mentioned, we are pleased by our monthly loan volume trends and continue to actively pursue ways to further our growth.

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

Questions and Answers

Operator: [Operator Instructions] The first question today comes from Alice Li with Credit Suisse.

Alice Li: Hi, thanks for take my question. I have 2 questions. The first one is about the P2P registration. As you mentioned that the P2P registration is likely to be delayed. So how would this affect your business operations? Also as you mentioned that in your loan volume guidance, you assume that you will receive the registration approval later this year. So if the registration is later than expectation, how will you mitigate the negative impact and trying to achieve the growth? This is my first question.

And my second question is about your borrower acquisition cost. So your new borrower acquisition has slowed down. What's the chance of your approval rate and acquisition cost per new borrower this year? And given the 36% rate cap, have you upgraded your borrower group? Also under what conditions will you feel more comfortable to acquire the new borrowers? Thanks.

Simon Ho: Thanks Alice. So as I mentioned just now, the first question on the P2P registration and the impact on our business, as to obviously how long the P2P registration will be postponed for, we don't know. There is no revised time schedule as yet. We are well positioned for regulations. And regulations will be positive going forward, we believe, for leading players like ourselves.

In the near term, it is obviously unclear whether the loan balance cap imposed by the Shanghai authorities will continue to remain throughout this period or not. We are actively pursuing ways to grow and drive profits, even in this environment. So for example, we are looking to expand the institutional funding on our platform, since the loan balance cap is mainly imposed on retail funded loans.

We will also look to use our microcredit company, which we completed acquiring in the fourth quarter of last year, to originate loans on its balance sheet. And we will continue to communicate with the authorities to see if there is room for relaxation for leading players like ourselves. And we will continue to use technology to drive efficiency and develop new businesses. Our first quarter results demonstrate how we can continue to be nicely profitable, even without significant loan volume growth.

Does this help answer your first question, Alice?

Alice Li: Yes. And may I ask what your latest funding breakdown, or say, in the first quarter, what percentage of the loan volume's funded by the institutional funding?

Simon Ho: Sure. In the first quarter, we are roughly running-- roughly about 10% of our funding platform is coming from institutions. And actually, I forgot, you had questions on customer acquisition costs and loan approval rates. And let me just come back to you there.

So the trend in customer acquisition costs in recent months have mostly followed the trend in our so-called conversion rate, which is the percentage of registered users that become a transactive borrower. The average cost of a new borrower has increased in the first quarter to around RMB150 to RMB160 per new borrower. That's up from roughly around RMB120 to RMB130 in the fourth quarter.

The cost in the first few months of this year has risen further, partly because of the decline in our loan approval and conversion rates. There has been some improvement lately, as we have increased our conversion rate, as we are now resuming growth. And so, as a result, we believe our customer acquisition costs may have peaked in the near term.

Alice Li: Thanks very much.

Operator: The next question comes from Stephanie Poon with Citi. Please go ahead.

Stephanie Poon: Hi, thanks for taking my question. My first question is actually a follow-up to the previous question about the funding side. So would like to get an update on the funding costs for both the institutional side and the retail funding. And also you mentioned the microcredit company you acquired in 4Q '17. So may I know what's the registered capital and the leverage cap there. So what is the maximum amount of loans that we can fund for that MCC license?

And my second question is regarding the average loan size. So we see that the loan size has actually been up quite a bit over the past 2 quarters. So would be great if you can help us understand what the reason or the traffic behind and also the outlook on that.

Simon Ho: Sure. I'll take the first, number one and number three, and I'll allow our COO, Feng, to take the microcredit company question.

The first question is about the funding cost or the rather now platform, what the returns investors are earning. Currently, those returns are around low double digits. And the cost is pretty similar between institutional and retail money at the moment.

And your third question is about the average loan size. You've noticed that it's gone up to around RMB3,000 in the first quarter versus about RMB2,400, RMB2,500, I think, in the previous quarter. This is mainly due to the discontinuation of our handy cash loan product, which has a much lower average ticket size, typically of maybe about RMB1,000 or even less than that. So when you take that business out, then the average loan ticket size on the overall platform goes up to about RMB3,000. So that's really the main reason.

And I'll hand over to Feng to address your microcredit company.

Feng Zhang: This is Feng. The currently capital for the micro-lending company is the RMB50 million. And we are actually working on adding more capital, up to about RMB500 million. So that would allow us to issue loans in the range of RMB500 million to RMB1 billion.

Stephanie Poon: Also, can I have a follow-up? What would be your actual percentage of funding generated from the institutional side? So because recently there's been news sourcing that probably the P2P registration may get delayed for 1 year or 1.5 years. So if the delay is longer than expected, and the loan balance cap will be in place for, say, the next 12 months, what would be your like targeted funding that you think you can manage to get from the institutional side to support your loan growth?

Simon Ho: Yes, I think, first of all, I just want to remind you clearly that the vast majority of the investments in our platform are and have been from individual investors. And our strategy has always been relying on mostly retail investors. Because we see having a strong retail investor base as important to us. We see it as a competitive advantage.

Of course, however, to grow our business in the near term, we may need to rely more on institutional investors. And while we are currently running roughly around 10% of loans of the funding from institutional, this percentage may head towards 20-30% level. I mean, we'll have to see how things go, I think. It's not a hard and fast rule. But clearly, we're dealing with a number of unknowns. But this is the direction we'll be heading.

Operator: The next question comes from Sanjay Sakhrani with KBW. Please go ahead

Sanjay Sakhrani: Thank you. Good morning. Just a couple of follow-up questions. Simon, just to your last comment on dealing with a number of unknowns, how soon do you expect to get some clarity on how you'll proceed going forward? And I have some follow-up questions just on the postponement and the technicalities as well.

Simon Ho: Yes, Sanjay, it has only been recent that, obviously, the news about registration postponement came through. So at this moment, we don't have any new information we can share on timing as such.

Sanjay Sakhrani: I mean, was there any specific reason why it's been postponed? And have other institutions gotten approval for registrations previous to this postponement?

Simon Ho: No. I mean, even if they were, it may not be valid. But my understanding is no. I mean, as you know, the original time schedule was for local governments to achieve or complete the P2P registration process by the end of June this year.

Now some of the reasons -- and this has been widely reported in the media, I'm just repeating what's been out there -- there's been, obviously, some concerns that because the implementation of the P2P registration is being done locally, at the local government level, even though the large framework on the principles have been given from Beijing at the central government level, the execution of such is done at the local government level. And there are differences in standards between different jurisdictions. And it's been well known that somewhere like Shanghai has one of the most strict, and the strictest and tightest requirements in the whole country.

And as a result, you've started to also see -- it seems that there are obviously some platforms starting to display some form of arbitrage going on. So I think that's possibly a reason why the authorities might want to take another look at this process.

Sanjay Sakhrani: And then, when you think about your originations guidance, how much risk is there to you succeeding in that, given all these technicalities and complexities in the markets?

Simon Ho: Yes. Clearly, the reason why we're mentioning this topic is there are -- we acknowledge that there are some risks. We are working very hard towards the RMB70 billion target that we've given out. However, obviously, in a pessimistic scenario, where the loan balance cap remains in place longer than expected, we're unable to attract additional institutional money, we believe our quarterly loan volume rate will still run higher than the first quarter level. I think we can sustain that level. And we estimate that our loan volume for the full year will still be close to the lower end of our RMB70 billion target for 2018.

So again, this is a short-term constraint. And of course, in the longer run, regulations, I think, will lead to a less competitive environment, more consolidated; and help players like ourselves.

Sanjay Sakhrani: One last question. In terms of the previous restrictions around funding, I seem to recall that you could sustain the amount of retail funding that you had, you just couldn't grow it. Has that now changed, so that you have to sort of plan some of that with institutional funding? And where exactly is this institutional funding coming from? Is it banks, or is it some other means ?

Simon Ho: Yes. So the institutional partners that we are dealing with right now are primarily mostly trust companies. And they have also been active on our platform last year. After, obviously, some of the regulation that came out towards the end of the year, there's been some reassessment. However, I think as long as the trust company third parties maintain certain requirements, they can continue to invest on our platform.

Sanjay Sakhrani: And on the retail cap, is there -- can you not now replace the retail funding that you had with a new one? Or are you just cut off from basically accumulating retail funding?

Feng Zhang: Yes. So I think you are right, the constraint is, that you have to decrease. So I think the request from the side of government was maintaining the retail funding outstanding at a certain level and do not grow it. And this became a constraint as our volume grows and we pick up growth, as the environment normalized and we get back to growth mode.

That's what Simon was mentioning, that additional growth, assuming that cap remains in place. And I do think there's some possibilities in the new environment that for even players like us, this may open up a little bit. But assuming it remains in place, then once we hit that level, additional outstanding growth needs to come from institutional funding.

Operator: [Operator Instructions] The next question comes from Robbie Li with Generation Capital. Please go ahead.

Robbie Li: Hi, management. Congratulations on the solid result. I Have 2 questions. So the first one is regarding the accounting change. So I just want to know what is the exact impact of the accounting change on your first quarter bottom line? I mean, you have already highlighted in your prepared remarks that there will be around RMB170 million impact on revenue. But I just want to know the exact impact on your bottom line for the first quarter.

And second question is, please give me more colors on the origination in the servicing expense. Why increase so much in first quarter this year? I think that's it.

Simon Ho: Yes. I think it’s a good question. I think, first of all, on the accounting change so first of all, the ASC 606, as you are aware, applies to all companies using U.S. GAAP. So you probably start to see this impact coming up.

And basically, you mentioning there's RMB176 million, that's one-off impact to the opening balance of our retained earnings. And there's RMB170 million impact during the first quarter of the year, which increased our revenues. As I said, both are due to the change in the way we collect our transaction fees, beginning in December, from an upfront model previously to monthly installments.

And under the old accounting policy, we would recognize the revenues only when we receive payment of the fees. But under the new policy, we recognize such revenues upfront upon loan origination, even though the fees will be paid to us over a series of months.

So if you want to say what the earnings impact is, it's really you could say it's RMB170 benefit to our revenues and also to our bottom line. But this RMB170 million really is what if the old accounting policy continued in the first quarter of '18. And this difference occurs only because we changed our transaction fee model in December in order to meet regulatory requirements.

Does that help you address this question?

Robbie Li: Okay, so there is RMB170 million one-off impact on the first quarter bottom line, but there will be no such impact going forward, right?

Simon Ho: Well, no. The accounting continues. So like we did in the first quarter we will continue doing in subsequent quarters. We will recognize revenues from our transaction fees upfront when the loan is originated. And this practice happened since January 1, and we will continue this practice of revenue recognition going forward. This is the new accounting standard.

Robbie Li; Ok, got it.

So your second question is with regards to the origination service and expenses. So you'll see that the origination service expenses increased if you do on an annual yearly basis, you'll see it increased about 45% year on year. And this is in part because of the headcount increase, the average headcount that we experienced in the first quarter of this year versus the first quarter of last year.

The major movement in our headcount really was a sizeable significant increase in loan collections, headcount, given the scale of the business that's been increasing, plus also the credit cycle, the delinquency cycle that we ran into towards the end of last year, and where we beefed up our loan collections team significantly.

But offsetting that decline, we had a consumption loan product which had offline sales agents. And that was discontinued in the fourth quarter. So there was some headcount savings from there. But net-net, there's been an increase in headcount, primarily because of loan collections.

But on a sequential basis, on a quarter-on-quarter basis, you'll see that the origination and servicing expenses actually declined about 15% quarter on quarter. And a lot of that is because of, actually, headcount decline. Our headcount in March, at end of March of this year versus December last year, was down around 10%. And that is driven primarily from headcount savings in customer service, in loan collections.

As I mentioned during the prepared remarks, we've been utilizing AI technology to drive operating efficiencies. Using bots in both of these places has definitely helped us drive operating efficiency during the quarter.

Robbie Li: So will this headcount decrease sequential trend continue going forward in your next 2 quarters?

Simon Ho: Yes, I think the outlook for our headcount -- I think for the rest of the year, our headcount is unlikely to grow much or significantly. And we will continue to leverage technology to drive these gains. I mean, there continues to be room for us to increase, continue the automation, in some of these processes and areas.

Robbie Li: Cool, got it. Thank you, very helpful.

Operator: The next question comes from Matthew Larson with Wells Fargo. Please go ahead.

Matthew Larson: Hi, thank you taking my call. My question was answered. I appreciate it.

Unknown Executive: Thank you.

Operator: As there are no further questions, now I'd like to turn the call back over to company for any closing remarks.

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

Operator: This concludes this conference call today. You may now disconnect your lines. Thank you.