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Q2 2020 Qudian Inc Earnings Call

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## CORPORATE PARTICIPANTS

**Min Luo** *Qudian Inc. - Founder, Chairman & CEO*
**Sissi Zhu** *Qudian Inc. - VP of IR*

## CONFERENCE CALL PARTICIPANTS

**Jacky Zuo** *China Renaissance Securities (US) Inc., Research Division - Analyst*
**Sanjay Jain** *Aletheia Capital (Hong Kong) Limited - Head of Financials*
**Shenghao Yu** *Needham & Company, LLC, Research Division - Senior Analyst*

## PRESENTATION

**Operator**

Hello, ladies and gentlemen, thank you for standing by for Qudian Inc.'s Second Quarter 2020 Earnings Conference Call. (Operator Instructions) Today's conference call is being recorded.

I'd now like to turn the call over to Qudian's Investor Relation representative. Please go ahead.

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**Unidentified Company Representative**

Hello, everyone, and welcome to Qudian's Second Quarter 2020 Earnings Conference Call. The company's results were issued via Newswire services earlier today and were posted online. You can download the earnings press release and sign up for the company's distribution list by visiting our webcast at ir.qudian.com.

Mr. Min Luo, our Founder, Chairman and Chief Executive Officer; and Ms. Sissi Zhu, our VP of Investor Relations, will start the call with their prepared remarks.

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 20-F as filed 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.

Please also note that Qudian's earnings press release and this conference call include discussions of unaudited GAAP financial information as well as unaudited non-GAAP financial measures. Qudian's press release contains a reconciliation of the unaudited non-GAAP measures to the unaudited most directly comparable GAAP measures.

We also posted a slide presentation on our IR website, providing details on our results in the quarter. We will reference those results in our prepared remarks but will not refer to specific slides during our discussion.

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

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**Min Luo** ***Qudian Inc. - Founder, Chairman & CEO***

First, I would like to thank all the investors, analysts and media who have taken an interest in joining today's call.

In the challenging second quarter of 2020, we continued to prudently operate our cash credit business. Although the COVID-19 pandemic has been gradually controlled in China, the damage from both the credit down cycle and the pandemic still lingers on vintages generated in the second half of 2019 and early 2020. As such, the D1 delinquency rate in the second quarter was sustained at a high level. As a result, in order to reduce risk, we remained stringent on risk management with rigorous credit standards and assessments. This approach kept the transaction volume of our loan book business relatively flat compared with the preceding quarter.

Let me also address the implications of the Supreme Court's decision to lower the court-protected, 1-year loan interest rate cap on private lending to 4x that of the loan prime rate. According to Decisions, the interest rate cap is not applicable to the lending business of financial institutions. Rather, this new policy is generally interpreted as only being applicable to private lending, while our business almost entirely involves financial institutions. However, it's important to note that the Decisions are newly introduced, and the policy is subject to further clarifications by courts and regulatory authorities. If the same interest rate cap were applied to our business as required by relevant courts or regulatory authorities, our profitability would suffer a material adverse impact, and we could incur net losses.

Now I would like to turn the call over to Sissi for more details on our results.

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**Sissi Zhu** ***Qudian Inc. - VP of IR***

Thank you, Min, and good morning, and good evening, everyone.

We have been navigating through the difficult market dynamics with a cautious and conservative approach towards our cash loan business. In the aftermath of both the COVID-19 pandemic and ongoing regulatory developments, the adverse market environment persisted throughout the second quarter. Although the D1 delinquency rate for our loan book business slightly decreased sequentially from around 20% in the first quarter, it was still at a high level of approximately 19% in the second quarter. In light of this situation, we maintained our deleveraging strategy for our loan book business to reduce risk exposure during the second quarter.

Through the continued implementation of stringent credit standards, we maintained a low credit approval rate, with transaction volume relatively stable compared with the first quarter and a leverage ratio of lower than 1x. We believe this conservative approach is the right course of action to best protect our net assets amidst the headwinds in the credit market.

Similarly, our institutional funding partners also deployed stricter credit standards for loan approvals given the heightened D1 delinquency rate on the open platform. Consequently, the amount of transactions on the open platform shrank by around 70% compared with the first quarter of 2020.

Aside from our credit business, our new initiative, the Wanlimu platform, is still operating at a small scale and early stage. Instead of lavish spending to boost the GMV of Wanlimu, we are trying to focus more on the healthy and prudent growth of the business.

In addition, we completed our strategic investment in Secoo in the second quarter. And we look forward to generating synergies in the luxury consumer business.

In conclusion, considering the current environment of a credit downtrend with high delinquency rates, we remain cautious and prudent with our cash credit business in an effort to protect our net assets. At the same time, we will be prudent and disciplined in the further development and management of our new business initiative, with the same approach to other business lines in the future. It's important for us to stay vigilant when it comes to the operating and preparing for different market dynamics, maintaining sensibility in our strategy and operations, all while cultivating opportunities to supplement our future development.

Now let me share with you some key financial results. In the interest of time, I will not go over it line by line. For a more detailed discussion of our second quarter 2020 results, please refer to our earnings press release.

Our total revenues were CNY 1.2 billion, representing a decrease of 47% from CNY 2.2 billion for the second quarter last year. Our financing income totaled CNY 581 million, representing a decrease of 41% from CNY 984 million for the second quarter of 2019, as a result of a decrease in average on-balance sheet loan balance.

Loan facilitation income and other related income decreased by 58% to CNY 255 million from CNY 610 million for the second quarter of 2019 as a result of the reduction of transaction volume of off-balance sheet loans this quarter, partially offset by reclassification of guarantee income in accordance with ASC326.

Transaction services fee and other related income decreased to CNY 4 million from CNY 398 million for the second quarter last year mainly as a result of a substantial decrease in the transaction amount of open platform business.

Sales income substantially increased to CNY 293 million from CNY 123.5 million for the second quarter of 2019 mainly due to the launch of the Wanlimu e-commerce platform.

Cost of revenues increased by 28% to CNY 366 million from CNY 286 million for the second quarter of 2019, primarily due to the increase in cost of goods sold related to the Wanlimu e-commerce platform.

Our sales and marketing expenses increased by 102% to CNY 157 million from CNY 78 million for the second quarter of 2019, primarily due to the marketing expenses related to the Wanlimu e-commerce platform.

Provision for receivables and other assets increased by 5% to CNY 590 million from CNY 495 million for the second quarter of 2019. The increase was primarily due to an increase in past due on-balance sheet outstanding principal receivables compared to the second quarter of 2019.

Our net income attributable to Qudian's shareholders was CNY 179.2 million or CNY 0.68 per diluted ADS. Our non-GAAP net income attributable to Qudian's shareholders was CNY 29.9 million or CNY 0.12 per diluted ADS.

So here's our prepared remarks. Operator, please open the floor for questions.

## QUESTIONS AND ANSWERS

**Operator**

(Operator Instructions) Our first question comes from the line of Vincent Yu from Needham & Company.

**Shenghao Yu** ***Needham & Company, LLC, Research Division - Senior Analyst***

My first question is about the sales and marketing expenses for the second half 2020 and the fiscal year 2021. So in terms of our capital investment plan for the e-commerce project Wanlimu, how should we think about the sales and marketing investments in the -- like the second half 2020 and the next year? And my second question is about the cooperation or partnership with like the financial institutions. With the tightening of institutional partners credit supply, is it temporary? Or is a new normal in your eyes? (foreign language)

**Sissi Zhu** ***Qudian Inc. - VP of IR***

Thank you, Vincent. This is Sissi. Let me address your questions one by one. So with regards to the sales and marketing expenses, for the second quarter, our sales and marketing expenses increased a lot compared to the previous quarter, mainly due to the launch of Wanlimu platform. But as I mentioned, we do not target to invest a lot of marketing dollars in Wanlimu platform. Instead, we focus more on the healthy and long-term development of this new business initiative.

So your second question regarding the collaboration with institutional -- financial institutions, as you may noticed that our open platform transaction volume decreased by over 70% in the second quarter and our number of financial institutions collaborate with us on the open platform decreased to less than 10. We believe if our delinquency rate on the open platform business continue to be in the heightened status, both the number of collaborations and the amounts of loan facilitation volumes will be like stable or even decrease in the future.

We currently don't have marketing plans to increase the number of [borrowers] (corrected by company after the call) on the platform, unless we see a turnaround on the delinquency. And plus, as you know, in August, there was a newly introduced rule regarding the 4x LPR. So the financial institutions are still waiting to see further clarifications on the interest rate cap. So right now, we believe maintaining the status quo could be best practice that we can do. Thank you, Vincent.

**Operator**

Our next question comes from the line of Jacky Zuo from China Renaissance.

**Jacky Zuo** ***China Renaissance Securities (US) Inc., Research Division - Analyst***

I have several questions here. Number one is about the recent regulation change, as you mentioned, basically the 4x LPR impact. So have we done any changes to our loan pricing after the decision from Supreme Court? Or if not, do we have any plan to change our current loan pricing? And probably, follow-on that is what is our loan volume outlook for the second half this year? And maybe another small question is, what is the reaction from our existing borrowers after the decision from Supreme Court? Have we received many inquiries on lowering the interest rates on their loans from borrowers?

And second question is about our loan product. I observed that we basically shortened the loan tenor and also lowered the average loan balance for existing borrowers. Do we see that trend to continue? And lastly is about the asset quality. As you show in the day 1 delinquency rate chart, we haven't seen much improvement on that. But I observed in the P&L, we actually booked a nearly CNY 200 million gains on the change in risk assurance liabilities. So does that show actually, we -- actually see some improvements or -- in assets, or -- actually, the performance in second quarter was better than we expected previously. And so just want to get some color on the assets quality trend going forward.

**Sissi Zhu** ***Qudian Inc. - VP of IR***

Jacky, this is Sissi again. Let me address your questions one by one. Regarding our strategies in coping with regulatory development on the rule of 4x LPR, we actually will stay very vigilant on the situation and stay very prudent to protect our net assets. We are still waiting to see further clarifications and interpretations from the financial sector regulators because our loan facilitation are through the financial institutions. If we need to make a change, they will be the first one to know how to make a change. So currently, our strategy is just to maintain our status quo, keep our prudent strategy and keep same pricing.

It is extremely hard to predict the future volumes because apart from the possible capping on the top line, the delinquency also will react to how other players play out the game. For example, if all the players in the market drop their loan volume all at once, the delinquency, the credit availability in the market will be dropping. And people who used to live on the rolling credit balances will have to default. Therefore, the magnitude of the potential default caused by the new rule is unpredictable to us. So that's why I said we should stay vigilant for further changes.

And for your second question, do we receive any inquiries from borrowers? Yes, we received some inquiries, but the amount is not that much. And regarding the D1 delinquency rate, it didn't drop a lot from the first quarter because our vintages for the fourth quarter of 2019 and the vintages for the first quarter of 2020 are still very young. So as we are -- as our loan volume decreased a lot in the first half of this year, the remaining portfolio that reflects the D1 delinquency rate are actually the default -- the remaining portfolio consisted more and more default borrowers. So that's why our D1 delinquency rate won't see a quick turnaround in the short time. But yes, as you may also noticed that our off-balance sheet gain and losses on the guarantee liabilities witnessed a gain this quarter. That reflects the portion -- that reflects the fact that the loan balance for our off-balance sheet loans decreased a lot in this quarter. And the delinquency results is not as bad as we predicted. So our accounting policy is to reassess the situation at the end of each quarter. So we believe this is the right way to do it.

Did I miss any of your questions, Jacky?

**Jacky Zuo** ***China Renaissance Securities (US) Inc., Research Division - Analyst***

Yes. Just following on your loan product. So we actually see that in the second quarter, you actually shortened the loan tenor and also reduced the average loan balance for borrowers. So will that trend continue in the second half of this year?

**Sissi Zhu** ***Qudian Inc. - VP of IR***

Right. So for the loan tenor, actually, it's our policy not to give guidance. But our current strategy on loan tenor and the loan balance is still consistent with the previous quarter.

**Operator**

(Operator Instructions) Our next question comes from the line of Sanjay Jain from Aletheia Capital.

**Sanjay Jain** ***Aletheia Capital (Hong Kong) Limited - Head of Financials***

Two questions, actually: one on the lending business and other on the luxury e-commerce business. So on the lending side, I know this is the third time among the 3 analysts who have asked the question, I'm asking the same thing. Give us some idea about what you are seeing in terms of trends for the second half of this year in growth and perhaps something on delinquency and also on the pricing side. I'm assuming that pricing continues as it is, but if you can talk about that. So anyone who is doing projections for you, how would you want them to proceed on the prospects for your lending business second half this year and next year ideally?

And secondly, on the luxury e-commerce, is it fair to say -- I mean, I can see that the selling revenue and the cost of sales is the same. So you're not making any money from the sale directly. But the sales and marketing expense -- the incremental sales and marketing expense, does it all largely pertain to the luxury e-commerce business? So on a sale of some CNY 293 million, you have sales and marketing expense, which is the loss effectively on that business of CNY 75 million, CNY 80 million. Is that the correct way of looking at it? And second component on the luxury e-commerce businesses, what are the synergies you are seeing right now? Is there any commonality among the 80 million registered users vis-à-vis the buyers on your e-commerce site?

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**Sissi Zhu** ***Qudian Inc. - VP of IR***

Thank you, Sanjay. So the delinquency rate for the future is really hard to predict. Although we see a recurring -- recovering trend for the delinquencies, but we're not sure about the impact, the possible impact from the new rule. If -- like I just mentioned, if all players drop their volumes all at once because of the new capping, the delinquency rate might increase a big amount because the liquidity market drop a lot. So it's very hard to predict. But currently, as we also put on the D1 deliveries chart, it's decreasing sequentially from the previous quarter, and it also decreased in August and September as well. But it's hard to predict the future.

The e-commerce business, our -- you're correct...

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**Sanjay Jain** ***Aletheia Capital (Hong Kong) Limited - Head of Financials***

Yes, sorry to interrupt. But delinquency, we are now in September, and the COVID peak was in February or March in China. The economy has restarted, all economic indicators and your own delinquency chart is suggesting that probably the peak of the credit problems are behind us. So as a lender, wouldn't you take some forward-looking view and give us some idea about what kind of growth, even if not open platform, what about the on-balance sheet lending? Why wouldn't you start growing? What is -- what more indication are you waiting for?

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**Sissi Zhu** ***Qudian Inc. - VP of IR***

Right. The reason why we want to keep the status quo is because we are not sure about what the further clarification and interpretation from financial factor regulators will be about the 4x LPR rule. If that's the case, I believe almost all the players in the market have to drop down volume. We don't want to run the risk of a quick deleveraging at that time. So that's why we believe keeping the current volume is the right strategy, is the right course of action for us right now.

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**Sanjay Jain** ***Aletheia Capital (Hong Kong) Limited - Head of Financials***

Okay. Fair enough. Have you had any discussion with the regulator on this?

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**Sissi Zhu** ***Qudian Inc. - VP of IR***

No, we haven't because we are not regulated by a financial sector regulator. But our funding partners are -- who [disburse] (corrected by company after the call) loans are regulated by the financial regulators. If they haven't heard any concrete clarifications, then I believe it's still ongoing.

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**Sanjay Jain** ***Aletheia Capital (Hong Kong) Limited - Head of Financials***

And would -- what about your on-balance sheet lending? Would it apply to that as well?

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**Sissi Zhu** ***Qudian Inc. - VP of IR***

Right. Our on-balance sheet lending is still disburse -- are also disbursed through financial institutions. So it is literally the same. So we believe it's the right course of action to deleveraging. Our leverage ratio is less than 1x right now. So it should be -- we should be relatively safer.

**Sanjay Jain** ***Aletheia Capital (Hong Kong) Limited - Head of Financials***

Okay. And the luxury e-commerce?

**Sissi Zhu** ***Qudian Inc. - VP of IR***

Right. So for the sales and marketing expenses, that increased a lot from the previous quarter to the second quarter is primarily our -- is primarily contributed by the Wanlimu platform. But we do not intend to spend the same amount of marketing dollars on this platform. And so we hope see a healthy growth trend. Instead of like many technology companies in China are spending lavishly on marketing dollars to boost the GMV, but we are already a listed company. We don't have to prove the quick GMV growth rate to attract funding. So we'd better focus more on the healthy development of a new business initiative. It's still an early and small-scale business. So that's why we didn't intend to make segment reporting for this business and for the number of users and et cetera. Sorry, we do not intend to report them separately right now. But on -- based on this business or other new initiative gets to a larger scale, we will do separate secondary reporting.

**Sanjay Jain** ***Aletheia Capital (Hong Kong) Limited - Head of Financials***

When do you expect that scale to be big enough? And what would be that scale in your view?

**Sissi Zhu** ***Qudian Inc. - VP of IR***

We don't have such predictions right now.

**Sanjay Jain** ***Aletheia Capital (Hong Kong) Limited - Head of Financials***

Okay. And any commonality, any synergy between the user base, which you have, versus the e-commerce buyers?

**Sissi Zhu** ***Qudian Inc. - VP of IR***

There isn't much synergies, to be honest, because our previous users for the credit business are blue-collar workers, mainly the blue-collar workers or people who work in the service industry. However, our Wanlimu platform are mainly for the luxury of scale products for the wealth group population in China.

**Sanjay Jain** ***Aletheia Capital (Hong Kong) Limited - Head of Financials***

Okay. Okay. And finally, on the convertibles. I think you have bought some more, right? What is the balance outstanding?

**Sissi Zhu** ***Qudian Inc. - VP of IR***

Right. For our CB, we cumulatively bought USD 199 million worth of face value. So yes.

**Operator**

(Operator Instructions) There are no further questions. At this time, I'd like to turn the call back to the company for closing remarks. Please go ahead.

**Unidentified Company Representative**

Sure. Thank you. Thank you, all, once again for joining us today. If you have further questions, please feel free to contact Qudian's Investor Relation Department through our contact information provided on our website. Thank you.

**Operator**

Thank you. This concludes this conference call. You may disconnect your line now. Thank you.

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