[LU] Lufax Holding Ltd.
Q4 & FY2023 Earnings Conference Call
March 21, 2024, 9:00 PM ET.

Executives
Yong Suk Cho, Chairman and Chief Executive Officer
Gregory Gibb, Director and Co-Chief Executive Officer
David Choy, Chief Financial Officer
Xinyan Liu, Head of Board Office and Capital Markets

Analysts
Emma Xu, Bank of America
Richard Xu, Morgan Stanley
Yada Li, CICC

Presentation

Operator: Ladies and gentlemen, thank you for standing by, and welcome to Lufax Holdings Limited Fourth Quarter 2023 Earnings Call. (Operator Instructions). After management's prepared remarks, we will have a Q&A session. Please note this event is being recorded.

Now, I'd like to hand the conference over to your speaker-host today, Ms. Liu Xinyan, the company's Head of Board Office and Capital Markets. Please go ahead, madam.

Liu Xinyan: Thank you very much. Hello, everyone, and welcome to our fourth quarter 2023 earnings conference call. Our quarterly financial and operating results were released by our newswire services and are currently available online.

Today, you will hear from our Chairman and CEO, Mr. Y.S. Cho, who will provide an update of our latest business strategies, the macro-economic trend, the recent developments of our business and the special dividend. Our Co-CEO, Mr. Greg Gibb, will then go through our fourth quarter results, and provide more details on our business priorities and outlook. Afterwards, our CFO, Mr. David Choy, will offer a closer look into our financials before we open up the call for questions.

Before we continue, I would like to refer you to our safe harbor statement in our earnings press release, which also applies to this call, as we will be making forward-looking statements.

With that, I'm now pleased to turn over the call to Mr. Y.S. Cho, Chairman and CEO of Lufax. Please.

Y.S. Cho: Thank you. Thank you for joining today's call. During the fourth quarter, the economic environment remained complex and SBOs continued to come under pressure.

Nevertheless, as we prioritized quality over quantity, we have now completed our major de-risking actions and will continue to carry out a prudent strategy.

We are confident that the strategic initiatives we have implemented form a solid foundation for longer-term growth and profitability, and believe that the cumulative impact of our strategic upgrades will optimize and re-calibrate our risk-return profile to align with the prevailing macro environment in China.

Now, let me provide some updates for the quarter. First, the broader macro environment remained challenging for SBOs. This is reflected in the SME Development Index published by the China Association of Small and Medium Enterprises, which declined slightly to 89.1 in the fourth quarter of 2023. Furthermore, the SME Business Conditions Index published by the Cheung Kong Graduate School of Business declined from 49.9 in September to 47.8 in December. This indicates that the SBO segment is likely to recover at a somewhat slower pace.

Next, let's turn to our business. Throughout 2023, we've made five major de-risking and diversification actions, including four mix changes and one business model adjustment. First, we have changed our segment and products mix. Our heavier concentration in the SBO segment and offerings of all SBO business loans generated healthy profits prior to 2022. However, with the change of macroeconomic environment, such concentration drove a deterioration in both our operational and financial results in the past 18 months.

To address this, we have strategically adjusted both product offerings and segments. In terms of product offerings, we've shifted from a predominant focus on SBO business loans to a more balanced offering of business and consumption loans. For our product portfolio, we've expanded our offerings to be more comprehensive, encompassing both installment and revolving payment options. Within the SBO segment, we've refined our focus by targeting customers with better risk profiles, specifically those in the R1 to R3 rating range.

Second, we have adjusted our regional mix. Since the second half of 2022, we've observed significant variations in credit performance and resilience across different areas. Accordingly, we have completed the reduction in our footprint, now focusing on higher-quality geographies with expected greater economic resilience.

Third, we have optimized our channel mix, especially our direct sales channel, which is the most important for our business. We recognized that our rapid historical expansion had resulted in lower productivity and higher risk with the direct sales team, and responded by optimizing the scale of our direct sales team. As a result, the number of direct sales team reduced from 47,000 at the end of 2022 to around 21,000 at the end of 2023.

Fourth, we have adjusted our industry mix, reflecting the relative sustainability of industries under the changing macro environment. In our internal risk assessments, we have assigned great importance to consideration of each industry's economic cycle stage within our models, and increased KYB and industry factors for enhanced model predictiveness.

Finally, we have completed the migration of our business model. As discussed previously, the high CGI premium charged by our business partners had negatively impacted our revenue and profit. We recognize that high third-party reliance reduced our tactical freedom. Therefore, we started negotiations with our funding partners at the end of 2022, and successfully completed transition into a 100% guarantee business model by the end of third quarter 2023.

In the fourth quarter of 2023, all the new loans were either granted by our consumer finance subsidiary as on-balance sheet loans, or enabled by our guarantee company under the 100% risk bearing business model, thus eliminating the drag factor of CGI.

On a single account basis, new loans enabled under the 100% guarantee model are expected to realize lifetime profitability, however, may record net accounting loss for the first calendar year due to higher upfront provisioning as compared with the loans under CGI model.

While this strategic shift enables us to capture greater economic value, it has also increased our risk exposures. Therefore, we will remain prudent and prioritize quality over quantity throughout 2024.

In terms of asset quality, compared to the third quarter, C-M3 flow rate experienced an increase in the fourth quarter. This was mainly driven by the reduction in our outstanding loan balances and the short-term impact from the restructuring of our direct sales team and branches. With the completion of all the restructuring measures, we have seen gradual improvement of the flow rate in the first quarter of 2024.

To sum up, during the fourth quarter, with the completion of de-risking initiative, the downside of our business is under control and we have stronger visibility of our business. However, the upside will still need more time due to our prudent strategy and the transformation of our business model.

Finally, over the past quarters, we have consistently heard our shareholders' request for us to improve investor return and capital efficiency. Considering the progress in our business de-risking and business model transformation, as well as our outlook for the growth and capital requirements for the next several years, we believe we have the capability and now is the right time to return value to our shareholders through a special dividend with an estimated dividend size of approximately RMB10 billion.

Thanks. I will now turn the call over to Greg.

Gregory Gibb: Thanks, Y.S. I will now provide more details on our fourth quarter and full year 2023 results and our operational focus for this year. Please note all figures are in Renminbi unless otherwise stated.

I'd like to start with an overview of our performance during the fourth quarter. During the fourth quarter of 2023, our performance remained under pressure from the complex macro environment and challenges faced by SBOs.

Our overall new loan sales were 47 billion, representing a year-over-year decline of 39.6%. This was mainly due to subdued demand for high-quality loans from SBOs, coupled with our prudent strategy as we transit to the 100% guarantee model. Among total new sales, approximately 40% was contributed by consumer finance as we transition our portfolio mix.

Fourth quarter revenue was 6.9 billion, a decrease of 44.3% year-over-year. This was primarily due to the reduction of our outstanding loan balance, which stood at 315 billion at the end of 2023, a decline of 45% on an annual basis.

We recorded a net loss of 832 million in the fourth quarter. This was mainly driven by elevated credit losses stemming from front-loaded provisions associated with loans enabled under the 100% guarantee model, heightened risk exposure under the model, and certain one-off non-operating losses.

Now, let's delve into our de-risking initiatives that we have made progress on in 2023. As Y.S. just explained, we've executed on our five major de-risking strategies, which included four significant changes to our business mix and transition to the new business model.

First, our segment adjustments have fundamentally shifted the new business mix in favor of R1 to R3-rated customers. In 2023, 73% of unsecured loan new customers were rated R1 to R3, compared to 49% in 2022.

In addition, strategic adjustments to our product offerings have resulted in a new business mix that reflects our significant de-risking measures. This has prompted a gradual transformation of our existing portfolio mix.

In 2023, consumer finance sales accounted for 34% of new loan sales, up from 12% in 2022. Concurrently, the proportion of unsecured loans and secured loans decreased to 44% and 22%, respectively, from 64% and 24% in 2022. As a result, our balance mix has shifted, with consumer finance balance as a percentage of the total balance rising to 12% at the end of 2023, compared to 5% at the end of 2022.

The proportion of unsecured loans decreased to 66% from 73% as of the end of 2022, while the proportion of secured loans remained flat. During 2024, we anticipate a continued consumer finance diversification, and majority of the unsecured balances will fall under the 100% guarantee model by the end of 2024.

Next, our regional adjustments have involved a targeted reduction of our footprint in less economically-resilient regions, characterized by relatively-higher risk. This strategic shift is reflected in our geographic coverage, which has decreased from over 300 cities at the end of 2022 to 146 cities at the end of 2023.

In terms of channel adjustments, we have concluded the restructuring of our direct sales. The number of direct sales team members was reduced from 47,000 at the beginning of the year to 21,400 by the end of the year. In 2023, the direct sales channel contributed 63% of new sales, up from 57% in the previous year.

Turning to our business model, starting in the fourth quarter, we've completed a strategic pivot as we fully transitioned to the 100% guarantee model. This move has transformed our portfolio mix and increased our risk bearing, as vintages run off and the loans under the new model takes shape. As a result, our risk-bearing by balance increased to 39.8% at the end of 2023, up from 23.5% at the end of the previous year.

During the fourth quarter, our overall C-M3 increased to 1.2% from 1.1% in the prior quarter. This was primarily due to a reduction in our Puhui business' outstanding loan balance, and the temporary negative impact from our geographic and direct sales restructuring in the past quarter. Although we have seen improvement in the C-M3 ratio in the first quarter, given our increased risk exposure under the new model, we will continue our prudent strategy to prioritize quality over quantity in 2024.

Now let's turn to our outlook for 2024. We expect the new loan sales of 2024 to be in the range of 190 billion to 220 billion, and the ending balance to be between 200 billion and 230 billion. Meanwhile, although we expect loans under the 100% guarantee model will be lifetime profitable on a single account basis, it is important to highlight that loans under this model may record accounting loss in the first calendar year due to higher upfront provisions.

Under our projected business scale, we believe we have a strong balance sheet to support the business' operations, capital, and liquidity requirements. At the end of 2023, the leverage ratio of our guarantee subsidiary was 1.8x, far below the regulatory limit of 10x.

Our consumer finance capital adequacy ratio stood at approximately 15.3%, well above the required 10.5%. As for the balance sheet, we hold liquid assets of 84 billion, with our cash at bank balance outstanding at 39.6 billion.

With the strong capital position and visibility into our business growth in medium term, we are well positioned to further respond to our shareholders' consistent feedback to increase shareholder returns. And on top of the regular dividend and share buybacks that we have performed over the past 3 years, our board of directors has approved, subject to shareholders' approval, a special dividend of US$2.42 per ADS or US$1.21 per ordinary share with a total estimated size of approximately RMB10 billion.

To offer our shareholders full flexibility, each shareholder may elect to receive the dividend either all in cash or all in scrip. As we are dual-listed in the U.S. and Hong Kong stock markets, the shareholders in each market will have to follow the respective procedures for receiving the special dividend. More details will be disclosed in our announcements and the statutory circulars in due course.

The special dividend is subject to the approval of shareholders at the annual general meeting, which will be held on May 30 with a record date of April 9.

I will now turn the call over to David, our CFO, for more details on our financial performance.

David Choy: Thank you, Greg. I will now provide a close look into our fourth quarter results. Please note that all numbers are in Renminbi terms, and all comparisons are on a year-over-year basis unless otherwise stated.

As Y.S. and Greg mentioned before, our performance was impacted by the macroeconomic environment in which the small business owner sector has been under pressure throughout the period. Through strategic adjustments to a 100% guarantee model and prioritizing high-quality customer segments and better geographical regions, we sacrificed some of our business scale for a better loan portfolio quality in the future.

This strategic transition inevitably caused our average loan balance and total income to continue to decrease. Whilst the expected credit loss provision is required to be booked upfront in day one, boosting the accounting loss in early product lifecycle under the new business model.

In the fourth quarter 2023, our total income was 6.9 billion, decreasing by 44.3%.

During the quarter, our technology platform-based income was 3 billion, representing a decrease of 49%. Our net interest income was 2.3 billion, a decrease of 47%, and our guarantee income was 886 million, a decrease of 47%. All are basically in line with the decrease of outstanding loan balance, in which guarantee income decreased by a lesser magnitude due to the offsetting effect of an increase in risk borne by the company.

Turning to our expenses, we remain committed to cost optimization. Our total expenses, excluding credit and asset impairment losses, finance costs, and other losses, decreased by 33.2% year-over-year to 4.4 billion this quarter, as we continued to enhance operational efficiency. In the fourth quarter, total expenses decreased by 38.5% to 7.9 billion, from 12.9 billion a year ago. This decrease was primarily due to decreases in credit impairment losses and sales and marketing expenses.

Highlighting just a few of the key expense items here, our total sales and marketing expenses, which mainly include expenses for borrower acquisition costs, as well as general sales and marketing expenses, decreased significantly by 45.9% to 2 billion in the fourth quarter. The decrease was mainly due to decreased loan-related expenses as a result of the decrease in the new loan sales and decreased retention expenses as well as referral expenses from the platform service attributable to the decreased transaction volume.

Our credit impairment losses decreased by 43% to 3.6 billion in the fourth quarter, primarily due to the decrease in provision of loans and receivables as a result of the decrease in loan balance.

Our finance costs decreased by 90.1% to 50 million in the fourth quarter from 501 million in the same period of 2022, mainly due to the decrease of interest expenses as a result of repayment of Ping An and C-Round Convertible Promissory Notes during the year.

As a result, net loss for the fourth quarter was 832 million, basically flat as compared to 806 million net loss in the same quarter of 2022. Meanwhile, our basic and diluted loss per ADS during the fourth quarter were both RMB1.48 or USD0.21.

Turning now to our balance sheet, with abundant cash, we had repaid the outstanding bond of 2.1 billion, and optionally convertible promissory note of 8.1 billion throughout the year 2023. After all these debt repayments, as of December 31, 2023, we have total equity attributable to owners of the company of 92.1 billion, a cash balance of 39.6 billion and financial assets at fair value through P&L of 28.9 billion.

In terms of capital, as of the end of December 2023, the two main operating entities are well-capitalized. Our guarantee subsidiary's leverage ratio was only 1.8x, as compared to a maximum regulatory limit of 10x. And our consumer finance company capital adequacy ratio well stood at approximately 15.3%, well above the required 10.5% regulatory requirement. Overall speaking, we are in a net cash position after taking into account all the external debt.

All of these factors offer substantial backing for the company to navigate through the changing macroeconomic environment and the transitional period, while providing foundations for us to continuously rewarding back to our investors.

That concludes our prepared remarks for today. Operator, we are now ready to take questions.

Questions and Answers

Operator: Thank you. We will now begin the question-and-answer session. (Operator Instructions). Emma Xu with Bank of America Securities.

Emma Xu: I think first and foremost, everybody cares about this special dividend. So what's the consideration behind this RMB10 billion special dividend? What are the key numbers or information that you rely on to arrive at this 10 billion special dividend?

And I have another question about your asset quality. So your flow rate, a leading indicator for the delinquency, continued to rise in the fourth quarter to 1.2%. But I also noticed in your report, you also mentioned that you actually see improvement of the flow rate in the first quarter or quarter to date. So could you tell us how much improvement you're already seeing in first quarter? And what's your expectation for the overall asset quality trend in the coming quarters?

Y.S. Cho: Okay. Thanks for your question, let me answer. Let me start with why we believe now is the right time for this special dividend. With successful completion of our five major derisking initiatives I mentioned, including four mix changes and one business model adjustment, we believe now the risk is under control and we have a clear visibility of our capital requirement for the coming next two to three years.

And then our stock has been traded at less than 0.2x PB, and we have been continuously requested by investors to enhance investment return. Now you see that our ADS price, if you compare with our -- the cash per our ADS is far lower, far lower. So the market has not even reflected the available cash on our book in our valuation. So we hope to unlock hidden value behind our cash on hand by increasing our shareholder value through this dividend.

And if I explain why we arrived -- how we arrived at this amount, why RMB10 billion, right, at this number? Of course, we first started with our future three years development potential and how much capital we need to support the development. And then we also assumed -- in this characterization, we also assumed a reasonably large buffer to increase our stable operation in the future, so this is how we arrived at RMB10 billion. And then the size of the dividend, it seems maybe very big compared with our market cap, but I want to emphasize, actually, it is only just roughly 10% of our net assets. So this is reasonably a good amount, I believe.

And then to answer your last question about asset quality, let me explain first about what's going on with our consumer finance business. Their NPL ratio has been consistent at around 1.5%, 1.4%. And then if I explain about the Puhui side, we said C-M3 net flow ratio for Puhui loans increased from 1.11% in the third quarter last year to 1.25% in the fourth quarter last year, right? And this increase is mainly due to reduction of our Puhui's outstanding loan balance and the temporary impact from our adjustment in our geography and direct sales restructuring. But fourth quarter, we see improvements in net flow. And we believe with the completion of all those restructuring measures, we will see gradual improvements of flow rate in the coming quarters.

And also, you understand the old portfolio that we booked before 2023 is of worse quality, and that portfolio is now running off. So when we get to the end of 2024, our legacy portfolio, or in other words accounts we booked before 2023, will take nearly 10% of the total portfolio. So in that sense, I think our gradual continuous improvement is of no doubt.

Emma Xu: Thank you. This is very helpful.

Operator: Richard Xu with Morgan Stanley.

Richard Xu: A couple questions from me. First of all, on capital again, after the special dividend, what do you think the capital needs to support the growth for loans? Will there still be enough buffer given obviously, most of the loans will be guaranteed by your own capital at the moment?

So on the flip side, given the projection on the reduced loan volume, are there still room to further reduce some of the -- maybe the capital base, and then do more special dividends with the smaller loan balance (inaudible) the question (inaudible) --

Gregory Gibb: Go ahead, Richard.

Richard Xu: Yes, lastly --

Gregory Gibb: You were just cutting off there. Could you just repeat the last two sentences?

Richard Xu: Sure. I just wanted to say like, one, is there enough capital to support the loan volume growth after the special dividend? And secondly, are there still potentially excess capital, if the loan volume will be smaller, right, whether there's opportunities for another special dividend down the road?

And then lastly is the funding cost trends that we're seeing at the moment. So two on the capital, and one is on the funding cost.

Gregory Gibb: Great. Richard, thanks, this is Greg speaking here. Overall, we have gone through, as Y.S. was just laying out, quite a comprehensive process looking out over the next couple of years on expected industry trend, our relative growth trend, capital requirements, liquidity requirements, a buffer, we operate multiple licenses. We obviously have the guarantee license; we have the consumer finance license; and we always keep our mind open for other licenses in the future.

So after going through all that, we arrived at, given our significant cash position, a view on what we could release today that gives us still a very substantial buffer going forward over the next couple of years. Obviously, our outlook for the market right now is still quite prudent. We're still focusing on quality over quantity, but if in a year or two, that macro situation were to change, and there were more opportunities, we've certainly retained enough capital that we can deploy in our current licenses to meet higher growth.

So I think that your question is whether or not there could be additional capital released down the road. We're not considering that for the moment. We want to keep our flexibility for maybe a more positive market outlook, let's say, 12 to 24 months down the road.

So I think our strategy here has been to provide the reward to make it meaningful, to deliver it in a way that allows investors to make a choice on whether they want to take some cash, or do they actually want to effectively double-down with the company in taking shares to make that a meaningful number today. But while leaving the company flexibility to continue to do the right thing, and capture opportunities going forward with sufficient buffer. So that's, I think, the grounding or the ranging on this.

In terms of funding cost, we did see funding costs over the last 12 months continue to come down. There's been two drivers of that. One has been the overall lower rate environment. The second though has been the change in the mix of our new business between guarantee and consumer finance. Consumer finance is able to tap the interbank market, multiple funding sources, has a lower net funding cost than the facilitation model by working with banks and trust companies.

So as we continue to see the mix change, so that there is a greater proportion of consumer finance, even though we don't think the rate environment will necessarily drop that much in the foreseeable future, we do think that our mix change will continue to optimize slightly the overall cost of funds in the model.

Operator: Yada Li with CICC.

Yada Li: This is Yada with CICC. And my first question is by 4Q 2023, the company has completed the transition into 100% guarantee model, but the bottom line was still under pressure. And I was wondering what are the main causes and how long does it take before profits could be released? And what are the main drivers for the profitability recovery?

And secondly, for the consumer finance company, how was the profitability and the future development, how we could balance the growth of the SBO and consumer finance segments and which one could be the strategic focus? And lastly, I was wondering are we considering additional buybacks? And what is the main cause that we choose the special dividend instead of buying back?

Y.S. Cho: Thanks, Yada. Let me start with your first question. This is Y.S. speaking. Because of our decline in new loan volume, the revenue we generate from new book cannot offset the decrease caused by older book shrinkage. And on the 100% guarantee model, the new model, you know that we have to accrue a lot higher off-loan provision that delay the profitability of our new business.

But on a single-account basis, new loans that we enable under the 100% guarantee model is delivering lifetime profitability, but adjust record net accounting loss for the first calendar year because of the higher loan provision. So that's the reason of delaying profitability recovery.

And if I explain about what are the main drivers for profitability recovering, how can you understand this ahead? I would say three things, right? The first is actually the portfolio credit performance, which we can measure by net flow rate. And the second is optimization, further optimization of what Greg mentioned, operating costs and also importantly, funding costs. And then lastly, our pace, the pace of new sales loan growth. We decided these factors will mostly decide our profitability recovery in the coming years.

And then if I was to answer your last question, it was about why special dividends over buybacks, have you considered buyback? If you compare dividend versus buyback, we believe concerning the situation we are in, dividend has several more advantages. First, our ability to deliver a return to shareholders through buyback is quite limited because of low liquidity.

The second is, as a dual primary-listed company in U.S. and also in Hong Kong, we do maintain at least 25% public float by Hong Kong listing rules. And our current public float is only less than 32% now. So we have very, very limited space for buyback at this moment.

And this time, our dividend, it comes with an option to choose cash or scrip. So we believe this provides more flexibility than buyback to our shareholders. So that's the reason why we decided to provide a special dividend over buyback.

And then one more question there?

Gregory Gibb: Yes, Greg here. On consumer finance, basically, 2023 was the third kind of full year of operation for the company. And it has been scaling up from scratch when the license was acquired. So 2023 is a profitable year for consumer finance. As the scale of that business continues to increase its relative efficiency, there's still some room there as it continues to scale up and we change the overall mix of the portfolio.

The question of how do we balance this and what is our main strategic focus going forward? So I think the way for us to describe this is our main strategic focus, our differentiation in the market, remains around serving the small business owner. This is still our core element. Where we see consumer finance playing an important role is really in two ways.

One is that we do believe that there are good consumer finance opportunities to work through multiple channels to diversify our product offering into providing more smaller-ticket, shorter-term loans that makes us to be more nimble in a dynamic environment, but also providing these capabilities to small business owners as well because small business owners sometimes act in the capacity of their company needs, which we cover under the Puhui business model. And sometimes, they have their individual needs.

Of course, we're looking at these customers from a full credit view, right? But we sometimes find that small business owners, once they have taken a long-term loan, they may still have smaller interim needs. And so we want to be in a position to serve these customers kind of on a longer lifecycle with more opportunities to interact with them, and through the interaction, creating more data points to understand them and their needs. So it is a way -- consumer finance is a way to diversify our product offering, to provide some nimbleness in terms of ticket size, to provide some additional data in terms of behavior, as well as additional touch points to our existing customers, as well as a deeper reach into the market.

So we will continue to have SBO as a core capability. But if you look at the mix between the Puhui model and the consumer finance model, you've seen that mix change quite a bit over the last 12 months. And that transitioned to a more balanced development you'll probably see continue in the near- to medium-term.

Operator: Thank you. That concludes our question-and-answer session for today. I'll now turn the call back over to management for closing remarks.

Liu Xinyan: Thank you. This concludes today's call. Thank you for joining the conference call. If you have more questions, please do not hesitate to contact the company's IR team. Thanks again.

Operator: Thank you. This conference is now concluded.