Funding Circle Holdings plc

Full Year Results 2018

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Transcript

KEY

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SD: Thank you very much for joining us at our maiden set of annual results, really pleased to have so many of you here and to have delivered on our IPO guidance. Really pleased with how the past 12 months have gone at Funding Circle, business is in great shape and we've got some exciting plans for the future.

I'm going to spend a few minutes introducing Funding Circle, I won't spend too long because I know everyone's pretty familiar with it, and then I'll hand over to Sean to talk about the financials and then come back to talk about the market and some of our plans for this year and there'll be time for Q&A at the end. And this is my first time as a public company CEO presenting results so please go easy on me a little bit, but obviously Sean's done this many times before so you can do what you want with him.

I'm really pleased with how the year ended, we delivered 55% growth in loans under management to reach £3.15 billion. Our platform continues to expand, we have over 60,000 small businesses on the platform now, over 85,000 investors and we continue to attract large commitments in both the US and UK of $1 billion and £1 billion towards the end of last year. In terms of financials, really pleased to have exceeded our IPO guidance around 50% revenue growth, we delivered 55% growth in revenue to about £141-142 million. Even at that higher level of revenue we delivered positive segment adjusted EBITDA margins of about 5%, it's the first time we've delivered positive segment margins and our adjusted EBITDA margin fell from about negative 27% to negative 20%, despite the fact that we continued to invest in growth and technology and pursued our strategy of growth over profitability.

We raised £300 million at the IPO, relatively modest IPO costs about £15 million so really put us into a very strong position financially, very strong balance sheet. And we continue to invest in marketing to really increase awareness amongst small businesses and that's why we kept marketing spend flat as we guided to at the IPO.

As you know, Funding Circle is a platform model. We connect up thousands of different investors with small businesses across multiple geographies to help them all succeed. The core of our platform is really about delivering an amazing borrower experience, underpinned by cutting-edge technology, very sophisticated data analytics and delivering a superior investor returns in the 5-

8% range across our different geographies, which compare very favourably with other fixed income asset classes.

The core of our platform is really about repeat, it's about building stable, predictable relationships with small business customers. We showed this chart at the IPO, but what you can see is that it continues; various different cohorts of borrowers continue to repeat with us on a very stable, linear basis. And that's because we deliver this great borrower experience. 85% of them tell us that they would always come back to us first in the future. And we're also pleased to provide some additional financial disclosure around the margins on these existing customers to help underpin our long-term profitability story because it's a really important part of what we do.

On the investor side of the platform, we continue to see existing investors increase their commitment through the platform year over year. We added a number of different new commitments and also an upsized commitment from the British Business Bank, which is the UK government. And really we're providing access to small business loans as an asset class that has been previously inaccessible to these types of investors. It's really just sat on bank balance sheets and we're really making it available to lots and lots of different types investors.

I'll just hand over to Sean to talk about financials.

SG: Morning everyone. So… going to start the financial analysis talking about loans under management, the driver of our servicing revenue, and originations, the driver of our transaction revenue. Loans under management grew 55% to over £3.1 billion. This followed origination growth of 40%. The growth figures here exclude property loans and for the geos, growth percentages are shown in local currency. Loans under management in the UK were well over £2 billion by the end of the year and the US were close to $1 billion, a figure that they exceeded in February this year. In the developing markets, loans under management doubled in both Germany and the Netherlands.

Year on year origination growth was tempered by some policy changes. Firstly, the decision in late 2017 to reduce the number of third-party referral partners in both the UK and the US. And secondly, in the US prior to Q1 we used to require existing borrowers returning for another loan to roll over the remaining principle of their original loan into a new loan but they didn't pay any additional origination fee on this rolled over balance. Post Q1 borrowers had the choice to roll over into a new consolidated loan or maintain two loans. This actually led to less rollovers and lower new originations but revenue remained unchanged, so yield actually increased. The impact of these policy changes was most pronounced in the US where they lost probably about 20 percentage points of origination growth as a result.

Revenue growth of 55%, excluding property, saw revenue exceed £140 million for the year. The growth was faster than the 40% origination improvement due to a combination of three things. Firstly, 18% of revenue coming from servicing revenue that grew in line with loans under management. Secondly, higher other revenue and lastly better transaction yield, which improved from 4.6% of originations in 2017 to 4.9% of originations in 2018 and actually exited the year at a yield of over 5%. This higher transaction yield being a function of price rises across all geographic segments rather than any variation in loan tenures or increased risk. And revenue from existing customers, which includes servicing fee revenue as well as the transaction fee revenue on repeat borrowing, grew by 67%. This meant existing revenue in 2018 was greater than new revenue in 2017 and represented 43% of total revenue for the year.

At a geographic segment level, the group reported a profit for the first time of £7 million. All geos improved the previous year's levels of profitability. The UK grew by 29% with losses in both the US and developing markets reducing. This was very much a function of the business and each territory growing quickly and benefiting from economies of scale as well as building a larger back book of borrowers that firstly drives servicing revenue on loans under management and also feeds on repeat borrowing. This improvement being after continuing to invest for growth, with marketing remaining at 41% of revenue for the group as a whole. Segment margins also improved markedly in the US and developing markets and only fell slightly in the UK as marketing spend increased to 40% of revenue, including the cost of above the line or brand marketing campaigns.

Now I'll do some commentary on the individual geos. The UK approached £100 million in revenue, up 43% with faster growing existing customer revenue now close to 50% of the business. In the past we reported unit economics on a first loan and a repeat loan basis across the lifetime and this was hard to tie to the P&L. As Samir said earlier, we've listened to the feedback and we've now introduced a P&L view that splits revenue and segment margin between new customers and existing customers. The existing customer base being a key driver of longer-term profitability. As existing customers are familiar with the product offering there is no marketing spend, which can drag on margins, and as such existing customer margins in the UK in 2018 were 64%. Conversely the investment in marketing restricted the new borrower margin to negative 16%.

In the US, revenue was up 70% in dollar terms to nearly $50 million. As a less mature market than the UK or a less mature business in the UK, existing customer revenue was only 35% of the total but it did more than double in the year. The smaller scale of the business compared to the UK means new and existing customer margins are lower than in the UK and the weighting towards new borrowers means the overall business was loss-making in the year, despite marketing spend falling to 42% of revenue. Looking ahead though, the US will be segment profitable later in 2019.

Developing markets revenue almost trebled in the year to €12.7 million with strong growth of new borrowers and the growing book of loans under management adding to existing customer revenue. Germany and the Netherlands are growing at a similar rate but existing customers are not yet profitable as the business lacks scale and is probably two-three years behind the US.

Adjusted EBITDA at a group level increased to a £28.5 million loss but the loss margin fell from 27% in 2017 to 20% in 2018. A segment profit of £7 million was offset by £24.5 million of product development spend charged to the P&L and increased corporate costs, that included operating costs of PLC post IPO. Gross product development costs were £35 million, up 46% year on year with more charged to the P&L compared to 2017 as amounts capitalized as intangible fixed assets were similar each year. The increase in spend being mainly a function of additional software engineers to develop our marketplace ledger platform, as well as to automate our processes. Free cashflow, defined as the sum of operating and investing activities and before financing activities, rose to £42 million outflow. The main difference to adjusted EBITDA being the £11 million of capitalized development spend, which is treated as intangible fixed assets.

If we look at the statutory P&L format, we see that share-based payments charge of £8.6 million included 3.6 million of employers' national insurance costs that arose as the business neared IPO. Cash IPO costs of 15 million were incurred with 5.9 million booked to the P&L and the balance recorded against share premium. R&D tax credits were again received, totalling £1.4 million.

Cash finished the year at £333 million, with the movement of the year essentially being free cashflow and net IPO proceeds of £285 million. From the balance sheet perspective, net equity rose to over £400 million following the capital raise. I'm now going to hand back to Samir to talk about the market but will be back later to talk about the outlook but I suppose what I would like to say is I'm really pleased with the financial performance of the year and hitting all the metrics that we guided to at IPO. Thank you.

SD: Thank. I'm going to talk a bit about the market and where Funding Circle is positioned and then our long-term strategy. Across all of our markets we continue to take share, we reached a high of 2.6% market share in the UK and in the US continue to build and in Germany and the Netherlands as well. But you can see that we're still a very small part of the overall addressable market. If you remember at the IPO we set out how we target loans typically below 500,000 pounds, euros or dollars, typically in the very prime part of the market, so we exclude larger loans, commercial mortgages, high-interest lending those above 25% APR. So we still think there's a lot of runway to go and that's why we continue to invest in growth over profitability.

What we've set out here is our competitive position versus the banks and we're a small part of the market. But at the IPO we also set out the two main categories of other competitors that we saw. That's captive networks, payment companies, e-commerce companies, people that you're probably all familiar with; and then typically balance sheet lenders that operate online, typically in the higher interest space. And what you can see is that Funding Circle comfortably is the largest online small business loan provider by loans outstanding. We really do sit head and shoulders above everyone else globally but clearly, as I said before, the banks are really the biggest part of the market and the main competition.

So a few fun facts. If you look at net new lending, so that's gross lending less repayments that come back from borrowers, this is really the Bank of England and the Treasury's preferred measure of how much money is going into the economy. Funding Circle actually did more net new lending in 2018 than the entire UK banking system. So you can just start to get a sense of the measure of how much of a contribution we are able to make. Part of the reason the British Business Bank and the UK government like working with us is because we're really helping stimulate the economy, creating jobs and helping small business borrowers.

We've not really talked too much about our US business. We went to the US in 2013 and Germany and Netherlands in 2015, so we've been in the market for about five years. We recently passed $1 billion of loans under management in the US. If we were a bank and we're not a bank but if we were a bank, Funding Circle would actually be one of the top 50 banks in loans below $1 million in the US. We couldn't get below £500,000 but you'd imagine we're larger there. And bigger than 5,100 other banks. Hopefully you can really start to get a sense that we're starting to penetrate markets outside the UK, really starting to make a big difference although clearly a way to go until we're bigger than American Express and Bank of America.

In terms of lending trends, small business loans remain below the levels they were at in 2011 and pre-crisis levels. Banks have been pulling back from this part of the market due to the worst capital treatment on the loans, the fact that they're difficult to serve and have really been expanding more in mortgages and larger corporate loans. It's a different story in consumer lending so in consumer lending in the UK you are seeing that rise above levels in 2011 and above pre-crisis levels, but we're feeling quite good about indebtedness of small business borrowers, they still remain much less indebted than they were pre-crisis. And that shows in the insolvency trend, so what this graph shows is insolvencies indexed to 2008 where they started to tick up. Across all our geographies, we remain well below pre-crisis levels of insolvency and we're not seeing anything really on the small business side that concerns us. A small uptick in the UK but it came down at the end of the year, so nothing really there. On the consumer side you are seeing some normalisation in the US, losses coming up a little bit and in the UK we do see an uptick.

As you know, consumer lending and consumer services don't really affect us in the most part. It does on the margins, affect some of our smaller loans, younger companies, where we tightened a little bit towards the end of last year and we continue to be prudent in that part of the market, but as I said, for the vast majority of our portfolio we don't see much of an effect.

In terms of projected returns, these are the projected returns that we put out quarterly, there's been no change in those. What these show is the net returns on our loans across each geography net of the projected bad debt rates below.

I think what's unique about small business lending and that the product that we offer is we have very high loss coverage on these loans. If you look at markets like the UK, Netherlands, Germany, losses could treble. In the US, losses could double and investors would still get a positive return. I think that's important because we will have movements in bad debt rates, small movements here or there, and we've constantly published those, but those don't actually make that big a difference to the return number and that's the number investors on the platform really focus on.

It's a very resilient asset. I'm not going to go through stress testing again, but we have stress tests, we feel pretty good about where we're positioned.

In terms of strategy at the IPO, we told you we had this Funding Circle 2020, strategic plan. We continue to execute against that and that's got four main pillars. Driving a better borrower experience; investing in data tech analytics; continue to diversify our funding sources; building this highly scalable global business. And I'm going to talk through where we are on those and how we continue to progress.

On the technology side, we continue to rebuild our platform into a global market and into a global platform. We put our global marketplace platform live in the US, we're currently rolling that out in Germany and the Netherlands. We've put live our global collection systems, all of our collectors globally are on the same system now benefiting from all the technology enhancements we're doing. And we set out the IPO we have this important target for us of having 50% of loans automated by 2020 and we have over 150 engineers working on the global platform and that automation target. We're feeling very good about the progress that we're making.

We launched proprietary bank account transaction models in the UK and US last year. Looking at individual transactions, doing text mining and as the largest online small business loan provider, we feel really good about our position in the market to be able to take account of new innovations like open banking in the UK, PSD2 in Europe.

Having bank account data is interesting, but having bank account data that you can match to years of loan performance and build proprietary models is very, very key to being able to use this and we feel like we're one of the few, maybe even the only one, that can actually really take that data and use it.

We continue to focus on building the largest, we call it data lake now, it used to be called databases, but data lake, of small business data across all our different geographies. That's used for targeting, for marketing, for risk analytics. We added 1.2 billion data points into our data lake last year and we continue to, we think, be on the cutting edge of analysing small business data and definitely spending more time on this than I think anyone else.

In terms of driving a better borrower experience, you know one of our key focuses is to increase awareness and consideration, we launched our Captain Galactic advertising campaign in the UK and launched a few testing campaigns in our other geographies. Captain Galactic going into stratosphere - hopefully you saw the ads, hopefully you liked them. We've been focused mainly on TV and radio and we're seeing some early promising results in terms of improvements in unprompted awareness of borrowers and definite improvement in consideration to take out a Funding Circle loan.

Really we're trying to build trust and awareness. We’re trying to get small businesses to stop thinking bank first and start thinking Funding Circle first.

What we show here is weekly search volumes for business loans in the UK. We launched a smaller advertising campaign in 2017 that was a drummer and skipper, that's what I've showed some drums here, and Captain Galactic in 2018.

We typically front load these campaigns. We spend a lot more at the beginning and then we go down and have a base level because that's basically what we've found to be the most effective and efficient, but what you can see here, which is quite interesting, is that Funding Circle business search volume, is now significantly larger than online search volume for business loans. We feel like we've really emerged as the category leader online and as more businesses come online to take loans, as banks even try and move their customers online, we feel like we're really well positioned to take advantage of this trend.

Another interesting thing is that we saw this tail off or dip towards the end of last year in business loans search volume, with a little bit of uncertainty around Brexit. We feel like we were less effected by that, just given where we are in the market and our existing customer base, and we're able to continue to deliver all the guidance we talked about.

In terms of building a highly scalable global business, we set out at the IPO that having internationalised this business, we have aspirations to keep adding more markets and whilst we remain very focused on our core markets, there's a huge addressable market there.

I'm really excited to announce that we'll be launching in Canada in the second half of this year. Canada's a very attractive market. The small businesses there are attractive from a risk perspective, but also share many of the characteristics in terms of data accessibility, in terms of being underserved by the banks frankly. It looks very similar to the UK and Netherlands from our perspective. Germany and US are more similar in terms of having lots of banks. UK and

Netherlands and Canada have very concentrated banking system. We think we can make a big difference and the Canadian government's really been pushing getting alternatives into the market.

The fourth pillar we had in the IPO was about diversifying our funding sources and if you look at the evolution of the Funding Circle marketplace, we started out with fractional loans. So this is where retail investors could buy parts of loans. A retail investor can't come and buy a 70,000 pound loan - we would divide it into lots of little chunks and we launched that across all our geographies.

In 2013 we added whole loans. That was where institutions came to us and said, "I don't want loads of £20 loan parts, I want the whole loan and I want it to be separate from the retail platform." So we launched that.

In 2015 we launched a listed fund Funding Circle SME Income Fund and really the rationale there was to give access to equity income investors. Those that can't buy loans but can buy listed equities basically. So we're really pleased to continue that expansion of our investor products.

We'll be launching a private fund in continental Europe and a bond product in the US in 2019 and really what these do is allow us to access a much wider universe of investors. We've projected that the future investor TAM or the future amount of money we can access increases 4X to £2.5 trillion, and really gives us access to these other types of investors, which we're excited about.

So I'm just going to talk about some of the key highlights of these products and then Sean's going to walk you through some of the mechanics and then we'll finish with outlook and we'll take some Q&A. In the US, we'll launch a a bond product in the first half of this year. This really provides access to investors that can't or don't want to purchase loans. Some investors say, "Look, I can purchase loans, but I don't want 2000 loans on my system. I'd rather have one thing with a ticker that I can look at on my Bloomberg terminal."

Over the next two years we're targeting additional, more than $500 million additional funding in the US from this product. There is a regulatory requirement in the US that we hold 5% of the bonds for up to two years. So we will comply with that. That represents a very small part of the balance sheet and as we package these loans up, as we aggregate them for a few months, we do bear the credit risk on the loans while they get built up and then before they get sold, but typically that's the least risky part because borrowers can't actually default for three months. There's a small revenue and profit enhancement from this, so it will actually be accretive to the P&L and Sean will talk through that.

In continental Europe, what we've seen, there's a lot of investors are participating in these direct lending funds. So these are typically where these funds are lending to midsize corporates, typically 40/50 million ticket sizes, and we've had a lot of demand from these types of investors, you know insurers, pension funds, to actually produce a product that can allow them to get access to smaller SMEs, which is what we do. So again, we're providing access to investors that can't hold the individual loans but can invest in funds.

Over the next three years, we're targeting an additional €200 million of funding in Germany and Netherlands for this. It's typically pretty standard for the platform or the manager to put in up to 5% of the capital in these funds, which we will do, and again, a bit like the bond product, we will have some credit risk on our share of the loans in the fund for up to eight years as the fund does a three year life and then starts to pay down. Again, there's a small revenue and profit enhancement from this activity. So thanks. I'll just hand over to Sean to talk about the rest of the presentation.

SG: Thanks Samir. I'm just going to take a few moments now to explain how these new products will actually work and how they will impact our financial statements. I've actually included a bit more detail in the appendix on the financial statement presentation for you to get into the how it models.

But in terms of the mechanics of the bonds, if we start in the top left with the first issuance. So prior to creating the rated bonds we need to have sufficient loans need to be built up in the warehouse phase.

Loans originated on our platform will be funded by bank debt, which is shown in the light blue and our own working capital, which is shown in the dark blue in a ratio of about 3:1.

If we use an indicative warehouse size of £200 million, this would mean by the end of the warehouse stage, us having £200 million in investments, in SME loans on our balance sheet, we should be funded in part by £150 million of debt.

Now whilst this debt will be consolidated onto our balance sheet, it will be held in a separate bankruptcy remote entity that will have limited recourse to the rest of the FC group. So then at securitisation shown here in the dotted line, investors would buy 95% of the notes backed by these SME loans, with us retaining 5% for up to two years for regulatory reasons.

Now the cash from the sale of the notes would repay our working capital and the bank debt and the investment in SME loans would cease to be recorded on our balance sheet at this point. Instead we will be left with an investment in 5% of the bond notes shown here in purple and this investment then reduces as cash flows from the SME loans are used to repay principal as well as interest on the notes.

Then a second issuance would follow the same pattern, originating loans in a warehouse until securitisation, at which point we would keep 5% share of the bond notes.

So there's no set rules on how long the warehouse phase should be, but you know, a reasonable approach is five-seven months and then what the balance sheet will show at any reporting date will be very much a function of where we are in the phases.

In this example, at the first year end, the warehouse is not yet complete. Whereas in the second year end, the balance sheet will show risk retention elements of two issuances and a partial warehouse build. From a P&L perspective, the impact is small but welcome. Revenue will show net of the cost to serve and fair value adjustments with most of the circa £3 million of revenue and circa £2 million of EBITDA being earned in the warehouse stage. But it's also worth remembering the primary reason for this new product is to diversify our funding and access a large investor town.

If we turn now to the private fund mechanics. Once we're up and running we will record our share of the private fund, which will typically be about 5%, again shown in purple, and in investment phase our share will be quite static and we will be earning net returns, which will be shown as revenue, very much in line with the net returns of other developing market investors. Thereafter in the distribution phase, the investment will gradually reduce as principal repayments are made.

Then finally turning to the outlook for 2019. Our IPO medium term plan, which for the avoidance of doubt was through to 2020 remains unchanged. The focus being one of pursing growth over profitability.

Then we think first of 2019 prior to the impact of these new investor products and the accounting change presented by IFRS16. We are guiding revenue to be above £200 million with transaction yields remaining at 2018 exit levels, which will provide a year on year revenue benefit as we will be lapping lower average 2018 yields.

Segment margin, including the organic expansion into Canada, to approximately double with marketing spend as a percentage of revenue remaining flat year on year. Then after central costs fall into 20% plus of revenue, which includes the investment in product development and a full year of PLC related expenditure, adjusted EBITDA losses are set to reduce from 2018 levels. Capitalised development spend, which is recorded as intangible fixed assets, to grow modestly.

Then there's the incremental impact of the new products, and IFRS16. New investor products are to add two-three million to both revenue and adjusted EBITDA in the year. IFRS16 is to add circa £5 million of both a segment adjusted

EBITDA and an overall group adjusted EBITDA level, but have a minimal impact on loss before tax, which is similar to the pro forma 2018 impact I've outlined in the appendix.

Then finally, we will report our first quarter loans under management and origination figures on the 18th of April when we will put out our usual loan performance statistics.

Thank you very much for coming and for listening. We'll now take any questions.