

Funding Circle

Interim Results 2019

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Transcript



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Samir Desai:

Okay, great, we'll get going. So thank you for coming to Funding Circle for our H1 2019 results. What we thought we'd do is, I would talk a little bit about highlights, just talk about the Funding Circle story. I'll hand over to Sean to talk through the financials, and then we'll finish off with a bit of market analysis and the outlook.

Obviously, we put out an update in early July on our outlook for the rest of the year and we recognise that by saying that we will grow revenues by around circa 20% in 2019, that that's a change to the guidance that we put out previously, at the beginning of the year. However, based on what we're seeing in the macroeconomic environment and proactive decisions we've taken to tighten credit and protect investor returns, we think that's in the long-term interests of the business, and what we should be doing as a platform-based business.

So in 2019, we grew loans under management to a record £3.54 billion. That's nearly a £1 billion more than what we put into the IPO prospectus. Originations grew 14% to 1.19 billion. And we were pleased to secure a number of new funding commitments in our European geographies, in particular, which had been more nascent, but really starting to show a track record. And also, launched four new funding products, bond products in the UK and in the US, and fund products in Europe and the UK, which are really based around our strategic pillar of diversifying our funding sources.

Revenue growth was 29%, to 81.4 million in the first half and importantly, 46% of revenue came from existing customers and as you know, Funding Circle is very much a repeat based business, like many platform businesses and we make significantly higher margins off repeat customers, because we don't have the associated acquisition costs, so it's a very important driver of our long-term profitability.

Our UK segment margin was flat, at around 26%, despite the fact that we were increasing marketing investment and above the line advertising, substantially. But our group segment adjusted EBITDA margin was around 1%. So lower than the 5% last year, driven by higher losses in the US and in our developing markets business, really, due to the investment that we're making there. And they represent very large markets that we're excited about for the future.

So I just want to spend a few minutes talking about why we set up Funding Circle and where we think we are today. So small business lending is a very small part of what banks do. On average, it only represents around 0.5% to 2% of their balance sheets. They have much more of their assets in corporate loans, mortgages, credit cards, personal loans. So it's really an area that they don't focus a lot on, don't care a lot about.

But that's a big problem for society, because small businesses represent around 50% of GDP, around 60% of employment. So there's a big disconnect between how much banks care about this type of activity and how much society cares about it and we saw in the financial crisis, that banks were

really not delivering money into the real economy, delivering to small businesses. And we set up Funding Circle as a real, viable alternative.

And we're really proud of all the impact we've been able to have. So Oxford Economics ran an annual data analytics exercise on our loans. They found that in 2018, there was an incremental £6.5 billion of GDP added to the economies that we operate in, 115,000 new jobs created. So the lending and the activity we do is making a really big difference in the economies we operate in.

And the addressable market is still very large. So we've estimated with OC&C that the addressable market is around £470 billion in the sub 500K prime small business lending market. And whilst that's a small part of what banks do because, banks are as you know, very capital heavy institutions, they tend to only do small business lending in one of their countries, as opposed to multiple markets. But for a capital light platform business like us, it's actually a very, very large and attractive addressable market.

And you can see that we've taken share across all of our markets since the end of last year. Now, reaching around 3% market share in the UK and going over 0.5% market share for the first time in the US, which is clearly the largest of all the markets.

So Funding Circle, as you know, is a technology platform business. We have built a very sophisticated technology platform, aggregating huge amounts of data that allows us to attract in, credit assess, and then service small business borrowers. Our small businesses are not start-ups, they've on average been trading for about 10 years, over £1 million of revenue.

And we connect them up with thousands of investors, 92,000 investors globally, around 5,000 joined in the first half of 2019, with a number of different sources. Institutional investors, retail funds.

So what we've split out here is the repeat rate on loans, the average number of loans held by a small business customer in the UK, by time. And we've done a couple of things differently in this chart. We've now split that out by quarter, as opposed to just by year. And we've also extended it past 60 months, which we've not done before.

And what you can see is that we get this very, very stable, predictable repeat behaviour from small businesses. Small businesses love what we do, we have a net promoter scores in the 80% to 90% range and 82% of borrowers tell us they would always come back to Funding Circle first in the future, rather than go to their bank. So repeat is really the way we're building our business. We're really trying to deliver a great customer experience to these small businesses and develop a long-term relationship with them.

On the investor side, we generate returns in the 5% to 8.5% range and particularly in a low interest rate environment with low yields, which is expected to continue. Our asset offers a very attractive return, relative to

the duration that it lasts. If you look at the weighted average duration of the cash, that is actually outstanding, that's only about 21 months on average. So you're getting a 5% to 8% return on your money with a very short duration, that compares very favourably with other fixed income asset classes and that's why we continue to have robust demand to invest in the loans that we do, which previously had been inaccessible.

As I said before, we have a number of different sources. We have insurance companies, banks, asset management companies. Pleased to have launched our two new bond products. We believe that those will significantly increase the addressable market for investors. A number of investors prefer to invest in rated securities, listed securities on the bond side, as opposed to loans, and that allows us to access that part of the market.

Around 90,000 retail investors on the platform continuing to invest, continuing to get net inflows there. Supranational entities like the British Business Bank, European investment, KfW really lending with us, because of their low cost loans that we're providing to small businesses.

And also, on the fund side, we were pleased to launch two new funds. The Funding Circle European SME lending fund and the direct lending fund and the UK lending fund. We had commitments from various insurance companies, pension funds to go into those funds and those replace our listed fund, which was the Funding Circle SME Income Fund, that we agreed to return cash to investors on, in the first half of the year. Mainly because the associated costs of running a listed company, but also the hedging costs from taking pound sterling money and investing it in euros and dollars, was not, we felt, the optimal way of investors accessing the asset class buyer fund. So we're very much focused now on private single currency funds, which we think are a more efficient way of accessing the asset class. Even though the Funding Circle Income Fund delivered returns of around 16.5% since inception.

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

Sean Glithero:

Loans under management grew 37% to over £3.5 billion, up nearly £1 billion on a year previously with all geos delivering good growth. The US now has loans under management in excess of \$1 billion, having now originated over \$2 billion of loans to SMEs.

Originations of loans on our platform grew more modestly at 14%, reflecting the conscious tightening in the UK and US and funding deals signing later than expected in Europe, that led to origination growth falling to 1% in that geo. Growth figures for the geos exclude property loans and are shown in local currency.

US figures were again impacted by the policy change in April last year, to require existing borrowers returning for another loan, to roll over the remaining principle of the original loan to their new loan. Whilst revenue neutral, this did impact US originations by about four points of growth and group originations by about two points of growth.

If we move now to revenue, revenue in the half was in excess of £81 million and represented growth of 29%. Geo growth rates were similar, with the UK and US growing well and then on the right, we can see strong improvement in existing revenue, up 44%, mitigating some of the effect of tightening on new revenue, which grew 20%. Existing revenue includes servicing fee revenue, as well as the transaction fee revenue on repeat borrowing.

Transaction yield was 0.4 percentage points higher at 5.2%, reflecting mix and optimisation of pricing in the second half of 2018. Servicing yield was a touch lower, rounding to 0.9% but was only down five points in the period and this reflected some additional discount in the US and elimination of some revenue from our new ABS program, where we cannot charge ourselves a fee.

The chart on the left shows the build of revenue growth, which was not just a function of origination growth in the period. Origination growth drove 11 percentage points of the overall 29 points of growth, with a balance from servicing revenue that grew in line with loans under management, better transaction yield and then growth in other revenue that includes net investment income from our new investor bond products, which I'll talk to later. The policy change in the US, whereby a borrower's first loan is no longer automatically consolidated into repeat borrowing, as well as some foreign exchange changes, half and half.

If we turn to segment profit on the right, we see segment adjusted EBITDA was £1.2 million for the group, represented a margin of 1% and a full half and half. Whilst for the UK, adjusted EBITDA improved in line with revenue growth, losses increased in both the US and the developing markets.

For the UK and the US, a consequence of tightening is that the percentage of applications that convert to loans is reduced. This can offset the operational efficiency we gain from scaling, as tightening leads to marketing cost per new originated loan rising, and even rejected applications receive a level of scrutiny and incur cost to serve. However, in the US and the developing markets where the opportunity remains huge, we continue to invest particularly in marketing.

Also, in the US, we saw extra service fee discounts and additional loan repurchase costs that impacted profitability. Low repurchase costs or where lenders pay us a fee to buy back defaulting loans on their portfolio for a specified period. But looking at our funding profile for the second half, I'm expecting loan repurchase costs to be below 50% of first half levels, and then finally, in the developing markets, originations lagged investment in the business, as funding deals were delayed.

Looking in more detail at the UK, we see that existing customers now account for over half of revenue, with existing customer growth the driver of the overall 25% improvement in revenue. Compared to prior year, overall margins in the top right chart have stayed flat at 26%, despite the increase in marketing spend to 41% of revenue that's shown below.

This reflects net of tightening in operational leverage and the benefit of an existing customer base. Whereas the margin on new customers has weakened for full year 2018 levels, to negative 21%, existing customer margins have improved to a high of 68%.

In the US, the back book of borrowers is less mature than in the UK. Hence, growth of 37% was driven by a 42% improvement in new revenue. As you can see in the bottom left, this was in turn a function of marketing investment that rose to 50% of revenue. Overall margin of negative 31% was broadly flat, with a margin impact of extra marketing spend and low repurchase costs, offset by operational efficiencies elsewhere in the cost base. Existing customer margins were at full year 2018 levels, the new customer margin declined to 60% due to credit tightening.

Finishing with the developing markets of both Germany and the Netherlands, funding delays impacting new borrower growth, such that most of the 27% growth in the period related to existing customers, which in turn led to revenue from existing customers rising to 37% of the business. An overall margin of negative 88% was weaker than in 2018, as marketing spend increased as a percentage of revenue.

Some operational efficiency was also lost in sales conversion and the geo result included some initial start-up costs in Canada. However, existing customer margin was positive for the first time, at 11%. And just to reiterate our announcement in the July trading update, we have paused the launch of operations in Canada to focus on operations in our existing countries.

So moving back to the group view, the left hand chart shows adjusted EBITDA, which has increased to a £19.7 million loss with a loss margin broadly flat at 24%. A segment profit of 1.2 million was offset by £14.3 million of product development cost that have been charged to the P&L and increased corporate spend, that included operating as a PLC, post IPO. Together, these central costs remained at 26% of revenue as we continue to invest in data and technology.

On the right, to keep our free cash flow representative of the trading flows of the business, we have slightly amended the definition to include the payment of lease liabilities, and to exclude net investment and bonds and private funds. Free cash flow in the half was £28.1 million outflow and differed to adjusted EBITDA by £5.9 million of capitalised development spend on tangible fixed assets. This was mainly investment in new technology platforms, including progress towards our automation goals. £2.2 million pounds on tangible fixed assets, mainly property fit outs and IT hardware, and then £0.3 million of working capital, including those property lease payments.

If we look at these statutory profit and loss formats on the left and the items below adjusted EBITDA, we see the share based payments charge fell to £4.5 million pounds as a related provision for national insurance payments reduced, very much a function of change in share price. There was a rise in depreciation and amortisation, reflecting both increased capitalisation

development costs and recent property fit outs. The increase in finance income reflected higher cash balances post IPO and an income tax charge arose on R&D tax credits, which cannot be offset against past taxable losses.

Moving to the table on the right, you will see we have a new revenue stream net investment income. We explained at the March results how the launch of new investment products would generate income for us. This income is shown net, with the cost of servicing debt offset against the income on SME loans. More on that in a second.

But from a cost perspective, marketing spend rose to 43% of revenue from 39% in the prior period, and within the £35 million of spend, above the line brand expense doubled to £9 million. However, for the second half of this year, I expect that to be half of that at around £4-5 million. Whilst the expenditure on marketing has proved successful, doubling awareness, given the current economic uncertainty, we are scaling back as we take the learnings from these campaigns.

So just recapping now on our disclosure in March, that we're launching these new products to diversify our funding and to access a much larger addressable market, particularly in the US. To date, we have launched four new investor products, a bond program in both the UK and US, as well as private funds each in the UK and Europe. It's the bond programs that have generated the vast majority, the £1 million net investment income in the first half.

Just going back to the mechanics of how these bond programs work, and they're very much operating as we expected. We are currently building up a stock of loans in two different segregated warehouses. One in the US and one in the UK. These short-term loan investments are financed through a combination of very specific bank debt that is purely attributable to these purchases of SME loans, which is shown in the light blue here, and our own working capital shown in the dark blue.

In the second half, we will securitise these bonds, selling to investors that want rated tradable investments and not whole loans, and in fact we actually launched the start of our first securitisation program for the US yesterday. We will retain for up to two years, only 5% of the bonds sold for regulatory reasons. And the cash from the sale of notes will repay our working capital and the bank debt and will repay off the investment in SME loans, which will cease to be recorded on our balance sheet. We will then be free to use that working capital again, to build up another levered warehouse.

So those SME loans in our bond program are shown within short-term investments in our balance sheet. Of the £120 million of short-term investments on our balance sheet, 177 million relates to this bond program, of which around 80% is debt financed. The balance of £30 million is our working capital, that together with the 270 million of cash at the end of the period, represents our shorter-term available funds.

So if we bridge the starting cash of £333 million at the end of December to the 270 million of cash at the end of June, we see the free cash flow of 28 million, combined with this £30 million of working capital in our bond program. Then we have a further £6 million of seed investment in our new private funds. And then there's a small amount of other, which is essentially FX. So we have a balance sheet at the end of the period of an equity value of £377 million pounds.

Thank you very much. And I'll hand back to Samir.

Samir Desai:

Great, so I'll just finish off with some market data. So as you know, in our Q2 trading update that we put out in July, the net returns and bad debt rates on loans were stable. So we made no changes from the previous levels. But as you know, since the second half of last year, we had brought down some of the UK return estimates and that's what I wanted to spend a little bit of time talking about now.

So what the chart on the left here shows is indexed insolvency levels for companies and for consumers. And what you can see is that there's been a small uptick in company insolvencies, mainly driven by start-ups, so younger companies. And on the consumer side, we have seen a large increase in insolvency levels since the middle of 2016.

If you look at the chart on the right, what this shows is the unit default rate of loans that we can read 12 months later, so at 12 months on book. So for instance, in the H2 '17 number there, that would be what we could read at the end of H2 2018. And what you can see is that the vast majority of our portfolio, which is in the A+ to C risk bands, has been very, very stable, in terms of performance. We haven't seen market changes there. And that's because, as we've talked about many times, our portfolio is very much a prime, solid portfolio, the kind of loans that the banks would do, that we're competing against.

However, we have seen in our D and E risk bands, an increase in unit default rates, which we've been able to read really more recently. And as a consequence of that, we have been tightening credit standards in the D and E risk bands, such that many of the loans, the vast majority of the loans that were in this category, we will no longer originate today.

Our belief, having looked at the data is that that has been driven by the degradation in the consumer environment. We can match those loans to companies where the directors have lower consumer scores, they tend to be younger companies. So we feel good about the performance of the portfolio and the loans we're originating, and have been originating more recently.

And that's characterised in the return estimates that we've put out on the charts here and in our July update. We are generating returns, we believe, in the 5% to 8.5% range across all of our different geographies. But most importantly, the loss coverage on our loans, which is the ratio of the interest rate to the bad debt rate is very, very high. It ranges between 2x and 5x, depending on a different geography, which means that losses could double

or in some cases, go up 5x and investors would still get a positive return. The high yield that we're generating, coupled with the low annual loss rates and the short duration of the assets make this an attractive asset class and that's why we continue to see strong demand for our loans.

So I just wanted to finish with the outlook. There are no changes from the guidance we put out in Q2 at the trading update. We expect revenue growth in 2019 to be circa 20%, driven by the changes that we've done and the environment. We expect the adjusted EBITDA loss margin for 2019 to be better than 2018.

And our strategy remains the same. We're still very excited about the long-term opportunity for Funding Circle, the market share that we think we can get. We continue to focus on driving this better borrower experience, focusing on getting our customers to choose us as the point of the place they go to first for finance.

We continue to invest in technology and data and analytics. We're pleased with the progress we've made so far on the automation efforts that we're doing. And we're very much on track to have more than 50% of loans automated by the end of 2020, which is what we set out at the IPO.

We continue to focus on diversifying our funding sources and I think the new products that we've introduced are a testament to our ability to innovate and add new funding sources in this way, and we continue to focus on building this highly scalable, global business, getting more and more efficient and on the path to long-term profitability.

We remain very confident of delivering our stated strategy, and generating long-term value for shareholders and I and the team continue to be very excited by our mission and the big economic impact that we're delivering today.