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OnDeck First Quarter Earnings Call

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John Rowan, *Janney*

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Vincent Caintic, *Stephens*

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PRESENTATION

Operator:

Good morning. My name is Chris and I will be your conference operator today. At this time, I would like to welcome everyone to the OnDeck First Quarter Earnings Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. If you would like to ask a question during this time, simply press star then the number one on your telephone keypad. If you would like to withdraw your question, press the pound key. Thank you.

Steve Klimas, Head of Investor Relations, you may begin your conference.

Stephen Klimas:

Thank you, Chris, and good morning. Welcome to OnDeck's First Quarter Earnings Call. I'm here this morning with Noah Breslow, our Chief Executive Officer, and Ken Brause, our Chief Financial Officer. Our earnings release was issued earlier this morning and is available with our earnings presentation and financial supplement in the Investor Relations section of our website. Certain statements including those relating to our second quarter and full-year 2019 financial guidance are forward-looking statements. They are not facts and are subject to material risks and uncertainties described in our SEC filings. These statements are based on currently available information and we undertake no duty to update them except as required by law.

Today's discussion is also subject to the forward-looking statement limitations in the earnings release and our actual results could differ materially and adversely from those anticipated. During this call, we will use terms defined in the earnings release and refer to non-GAAP financial measures. For definitions and reconciliations to GAAP, please refer to the non-GAAP tables in the earnings release and the appendix of the earnings presentation posted on our website.

With that, I'll turn the call over to Noah.

Noah Breslow:

Thank you, Steve, and thank you all for joining us today. We had a very active first quarter advancing our strategic initiatives while generating solid financial results. As a reminder, our strategic priorities include building upon our success in the U.S. lending franchise, investing in our growth adjacencies including ODX, International and equipment finance, and advancing our capabilities in risk and technology while improving our funding profile and we made considerable progress on each of these in the first quarter.

In our U.S. lending franchise, we continued to grow the portfolio. We originated $636 million of loans, up 8% from the year ago quarter with increases in both term loan and line of credit volume. In fact, we generated roughly $150 million of line of credit volume in the quarter which was an all-time high for us. These originations resulted in 3% sequential loan growth and the portfolio now exceeds $1.2 billion. That is nearly a $200 million or 19% increase from a year ago with double-digit percentage growth in our U.S. and International operations.

Our direct channel continues to be our primary source of originations accounting for 43% of the quarter's volume. Given the attractive customer acquisition cost in the strategic partner channel, growing existing relationships and adding new partnerships remains a focus and we continue to have success there with record volume in that channel this quarter. We made some adjustments to credit policy mid-quarter to pullback in certain areas and our funding advisor channel volume decreased sequentially as a result. The flexibility of our multi-channel distribution network allows us to make quick adjustments to our portfolio flows and is a key competitive differentiator.

Now let's turn to our three growth adjacencies. First, ODX had a solid quarter. In terms of existing clients, Chase volume increased from prior periods and PNC began booking loans through the platform. While our relationship with PNC is in its early stages, I'm encouraged by the engagement and partnership with that team and we are on track to expand the roll out by launching additional marketing campaigns this spring and summer.

Our new partner pipeline developed further in the quarter with several prospects advancing to later stages in the process, and we continue to invest in developing the ODX platform in a way that will enable us to more efficiently add future banks.

Turning to international, we closed our business combination with Evolocity Financial Group on April 1st. As a reminder, Evolocity was founded in 2008 and has provided over CAD$250 million of funding since inception. The business is based in Montreal and has roughly 70 employees and approximately CAD$50 million in finance receivables consisting of term loans and merchant cash advances.

The combination creates a leading online lender to small businesses in Canada enabling us to better serve Canadian small businesses by offering a wider array of products and serve clients in all provinces. This includes Quebec, which accounts for approximately 25% of the Canadian market but we have not served that province in the past. It is truly a synergistic combination with Evolocity having a significant local presence, infrastructure and product diversity while OnDeck brings a stronger balance sheet, capabilities in technology and analytics and broader international lending experience.

In terms of transaction structure, the two companies came together under a common Canadian holding company. Evolocity contributed its full business to the holding company and OnDeck contributed its Canadian business plus some cash to account for differences in the net asset value of the contributions and OnDeck's majority ownership stake.

OnDeck holds roughly 58% of the combined OnDeck Canada which is comparable to the stake we have in our joint venture in Australia and we will consolidate the combined entity in our financial statements. The remaining minority stake is held by the Evolocity management team, all of which are continuing with OnDeck as part of the transaction, and the other previous Evolocity investors. The teams are now focused on integration which is progressing smoothly thus far.

Our business in Australia continues to grow and perform well and we continue to believe that our international operations will turn profitable next year.

Third, we advanced our equipment finance offering by in-sourcing key processes and starting to fund loans on our balance sheet. Recall we ran a pilot equipment finance referral program in 2018 and that continues. The learnings from this program over the last nine months has helped inform our underwriting models and our go-to market approach.

In Q1, we began transitioning more of the originations process in-house from our pilot partner and began to originate assets for our own balance sheet. We are currently focused on originating fixed rate loans between $5,000 and $150,000 with maturities of two to five years that are secured by essential use equipment. As we did with our launch of the line of credit offering, we are taking a measured approach to entering the market and so our origination targets this year are modest. However, the addition of equipment financing has been well received by our customers and channel partners and we remain encouraged by the longer-term growth opportunity.

Finally, with respect to our core capabilities, we are making progress on building out our technology stack and we continued to significantly improve our funding profile. We completed four financings totaling nearly $600 million in the first quarter that increased our borrowing capacity, extended duration, reduced cost and otherwise improved the terms of the facilities they replaced. Ken will provide some added color, but these transactions have addressed the maturities we had coming into the year.

We accomplished all of this while generating solid financial results. Our net income and adjusted net income were at the upper end of our guidance ranges and our gross revenue of $110 million was at the midpoint.

Loan growth met our expectations and our margin remains strong at 29.5% as the benefit of lower funding costs mitigated a lower portfolio yield reflecting higher delinquencies. As we mentioned last quarter, our credit metrics are normalizing. Our provision rate was 6.8%, net charge offs were 12.2% and our 15-plus day delinquency ratio was 8.7%. These metrics reflect impacts from the credit expansion tests conducted in the second half of 2018 as well as changes implemented to our collection practices which result in us retaining more late-stage delinquent accounts.

Additionally, we had some one-time effects in the first quarter due to the government shutdown and severe winter weather. Overall, the portfolio continues to perform as expected given a slightly more challenging small business lending environment in 2019 and Ken will walk you through the drivers of each metric.

Given our view of the small business lending environment, we tightened underwriting and increased our loan loss reserves. At this point in the cycle, we think a slight shift in origination strategy to favor loans at the higher end of our target demographic is prudent. This change will impact revenue growth this year, however, our full-year earnings expectations are unchanged.

We continue to find opportunities to improve the efficiency of our U.S. lending business while managing the timing and the magnitude of our investments to achieve income at our target levels.

One of the real advantages of the OnDeck model is that we can be very nimble and react quickly to changes in our portfolio or the lending environment. At this juncture, we believe a slightly de-risked stance is appropriate.

While the environment may shift quarter-to-quarter, the decade-long secular shift towards online borrowing amongst small businesses is accelerating as evidenced by the Federal Reserve Small Business credit survey that was published in April. The survey noted that of the small businesses seeking credit in 2018, 32% applied to an online lender, that is up from 24% in 2017 and 19% in 2016. Moreover, small businesses within our target demographic suggest they are more likely to apply to an online lender today than a bank, credit union or community development financial institution. That is a very powerful statement regarding the future of lending to underserved populations.

With that, I'll turn it over to Ken to walk through the financials and our updated guidelines.

Ken Brause:

Thank you, Noah, and good morning everyone.

Our first quarter results were strong. Net income was $6 million or $0.07 per diluted share and compares to a loss of $2 million or $0.03 per diluted share a year ago, and net income of $14 million or $0.18 per diluted share last quarter.

Adjusted net income, which excludes stock-based compensation and other note-worthy items, of which there were none this quarter, was $8 million or $0.10 per diluted share and compares to $6 million or $0.08 per diluted share a year ago and $16 million or $0.20 per diluted share last quarter.

Getting into the details, gross revenue was $110 million, up $1 million sequentially and $20 million or 22% from a year ago driven by higher interest income reflecting loan growth. Loans grew 3% sequentially and 19% from a year ago to $1.2 billion. Originations were $636 million, down 3% from the last quarter but up 8% from a year ago. While originations decreased from the fourth quarter, we did see an increase in application volume which validates the continued demand for our product.

Loan yield remained strong at 35.6%, unchanged from a year ago and down 100 basis points from last quarter. This sequential decline was largely a result of portfolio performance as the weighted average interest rate on the portfolio was essentially unchanged at approximately 45%.

Interest expense of just over $11 million was also unchanged sequentially despite a 4% increase in the average debt balance as our cost of funds rate improved 20 basis points to 5.4%. That rate improved 140 basis points from 6.8% a year ago despite a roughly 50 basis point increase in one-month LIBOR over the same period.

As Noah mentioned, we made further progress improving our funding profile. In January, we closed an $85 million syndicated corporate credit facility with several banks which replaced the $30 million one that expired. This facility can be used for general corporate purposes and is priced at one-month LIBOR plus

300 basis points, which is about 125 basis point net savings from the prior one. In February, we upsized our Pioneer's Gate facility from $100 million to $150 million and reduced its cost by approximately 25 basis points to one-month LIBOR plus 175 basis points. In March, we announced that we amended and extended two separate bank facilities that aggregated to $360 million and resulted in a blended savings of over 70 basis points.

Those financings substantially addressed our funding needs coming into the year, so we're in a very strong liquidity position. The Evolocity transaction adds about $40 million of legacy commitments of which roughly $30 million are drawn. That debt matures within the next 12 months and we are working with the local team in Canada to refinance it at a more attractive cost of funds.

Net interest margin remained strong at 29.5% in the first quarter. While down 50 basis points from last quarter reflecting the lower loan yield, NIM improved by 170 basis points from a year ago reflecting the favorable trend in funding costs.

Now turning to credit. Our portfolio quality metrics are normalizing as expected. Provision expense was $43 million, up $3 million sequentially and $7 million from a year ago, and the provision rate increased to 6.8%.

Our 15-day plus delinquency ratio increased 120 basis points to 8.7%. About half of the increase was in the 90-day plus bucket and reflects ongoing impacts from the in-sourcing of collections on late-stage delinquencies which we've discussed for a few quarters now. The balance of the increase was in 15 to 89-day delinquent loans and reflects the roll through of the impact of the credit expansion tests we did in the second half of 2018 as well as the overall credit environment.

Net charge-offs remain near the low end of our 12% to 14% target range at 12.2%. The allowance for loan losses is now $147 million resulting in a reserve ratio of 12.5%. This reserve level reflects the growth in the loan portfolio, portfolio trends, and the growing proportion of late-stage delinquencies on which we hold higher reserves.

Total operating expenses were $48 million, up $3 million sequentially. Most of this increase was concentrated in the technology and analytics category and reflects some of the incremental investment in our strategic growth initiatives that we have discussed. Our adjusted efficiency ratio increased 41% reflecting the increase investment expense.

And this was the first quarter we accrued for income taxes. The effective tax rate was 24% which was a bit higher than our initial estimate of approximately 20% as we continued to refine our estimates for taxable income in the U.S. and our International subsidiaries.

Our balance sheet remains strong with growing levels of capital and liquidity. We adopted the new lease accounting standard which effectively grossed up our balance sheet by $28 million as we recorded a lease liability in other liabilities and an offsetting right of use asset in other assets. The net add predominantly relates to our office real estate leases and reflects the $10 million of deferred rents and other accrued lease expenses that were already in other liabilities.

Liquidity levels improved as we had approximately $340 million of available borrowing capacity under our roughly $1.2 billion of committed debt facilities as well as $60 million of cash and equivalents at quarter-end. Our capital levels remain robust with equity representing 26% of assets or a debt-to-equity ratio of just 2.7 times.

OnDeck shareholder's equity increased 3% since year end to $309 million and booked value per diluted share grew to $3.89. We continue to have a full valuation allowance against our net deferred tax assets of approximately $38 million or $0.50 per share. We will begin evaluating the potential for a partial release later this year.

Now turning to guidance, we are affirming the full-year 2019 income guidance we provided in February which calls for net income attributable to OnDeck between $20 million and $30 million and adjusted net income between $30 million and $40 million. We modestly reduced our gross revenue guidance range to $435 million to $455 million primarily reflecting lower asset growth than originally contemplated as we're taking a slightly more cautious view of the small business lending environment.

In terms of the other key performance indicator trends, we expect net interest margin to be stable year-over-year as a lower loan yield, reflecting credit normalization and our focus on originating slightly higher quality credits, is offset by funding cost improvements. We still expect the full-year provision rate to be near the midpoint of our 6% to 7% target range as our credit metric trends continue to normalize. We still expect our adjusted efficiency ratio to increase slightly from 2018, although we will actively work to manage expenses to achieve our income targets.

For the second quarter, we're expecting gross revenue between $108 million and $112 million, net income attributable to OnDeck between $4 million and $8 million and adjusted net income between $7 million and $11 million.

As Noah said, our first quarter financial results were solid and we continue to advance our strategic priorities. Our strong balance sheet and nimble operating model positions us well to capitalize on today's opportunities as well as those to come as the shift towards digital lending accelerates.

With that, let's turn the call back over to Chris and we'll take your questions.

Operator:

At this time, I would like to remind everyone, in order to ask a question, press star then the number one on your telephone keypad.

Our first question comes from Eric Wasserstrom of UBS. Your line is open.

Eric Wasserstrom:

Thanks very much. Noah and Ken, can you guys just maybe talk a little to what you saw in the lending environment that made you become incrementally more cautious, and I guess in particular, what it was about the strategic advisor channel that seemed, I think, particularly different than expectations?

Noah Breslow:

Sure, Eric. No problem. This is Noah. When we look back over the last 90 days, what we saw in the environment, there's really no single driver but we've been doing this now for over a decade, so we have a lot of data that we look at, kind of compare seasonality and what we see every year. And so, what we saw internally is that even when you adjust for the credit testing we did last year and also the change in collections practices which sort of drove the 90 plus part of our delinquency rate, the credit performance softened a bit for some of the 2018 vintages, so we saw that internally.

Then externally, small business optimism ticked down a bit from its all-time high. It's still high relative to historical levels but it did back off a bit and we are late in the cycle and then we did see a little bit more of an aggressive competitive environment. We did decide to make again, as Ken said, a slight pull back on our risk tolerance, focusing a little bit more at the higher end of our target demographic.

And then the piece about the funding advisor channel, that channel has a slightly higher natural risk element, so our pull back wasn't a choice specific to any one channel, but it was a little bit more across the board. It just hit that channel a little bit harder because of the inherent risk differences between the three different channels that we have.

Eric Wasserstrom:

Great. Thank you for that. Then just on the net interest margin, when you referred to the performance-based component, I'm assuming that means suppression or the non-recognition of potentially forgone NII on high or late-stage delinquencies. Is that what that is?

Ken Brause:

It's just the delinquencies in general. If people aren't paying us, we don't recognize the income. It doesn't help your yield.

Eric Wasserstrom:

Got it. Great. Then just lastly on expense. Of the $15 million that you had signaled would be incremental investments over the course of the year, can you give us a sense of how much of that was spent or deployed in this period?

Ken Brause:

Sure. I'd say probably around $3 million give or take of that $15 million was expensed in the first quarter. As we think about the full year, we said $15 million was the expected number. Obviously, there are timing issues as we implement things, so it could be a little bit light of that given the pace in the first quarter.

Eric Wasserstrom:

Thanks very much.

Ken Brause:

Thank you.

Operator:

Your next question comes from John Hecht of Jefferies. Your line is open.

John Hecht:

Thanks, guys, very much. First of all, you are targeting originations at the higher end of your range. Given the aforementioned component to credit, does that mean that you guys think that by the end of the year you would see an alleviation of delinquency and charge-off trends, or you just sort of try to manage into the range you're talking about right now?

Noah Breslow:

Yes. We did implement a slight pullback in Q1. This is Noah, John. We're already seeing some evidence of improvements in the early roll rates - we have a little bit of a situation where some of the testing from last year and some of the weakness from the 2018 vintages is flowing through but some of the earlier results are promising. I think that that's sort of point one.

Point two is, as we said in the prepared remarks, we do expect originations to be sort of flat to slightly down in Q2, but we do expect sequential growth again in the second half of the year heading into 2020 and that's been kind of our pattern for the last couple of years. There's a little bit of a seasonally trend in Q2 that is also going on here.

So, long story short here is, I think we're encouraged by the changes we made in terms of their impact on the portfolio. We do see us returning to sequential originations growth in the second half of the year. Again, we've been doing this business for over a decade, so a lot of this how we just sort of manage the business through a variety of different environmental conditions.

John Hecht:

You talked about a lot of activity in the ODX pipeline and yes some of the good growth within the active partners, can you give us a little bit more color there in terms of the pipeline, sales cycle and opportunity?

Noah Breslow:

Yes. We feel great about the overall opportunity. The pipeline is strong, it's wider than it's ever been in terms of the number of opportunities we're pursuing. As we said in the prepared remarks, we have folks moving to later stages of the consideration process. That's all we can say at this time.

John Hecht:

Thanks. I apologize, moving back to the ALLL. You're at 12.5% right now. Is that the new base? Should we think about any seasonal considerations there just in terms of modeling that migration over the course of the year?

Ken Brause:

Obviously, the reserve is based on the expected loss in the portfolio. As we continue to roll out the late stage delinquency collection process and we're holding more of the 90 plus day delinquents on balance sheet, those loans have the highest reserve levels attached; we reserve about $0.85 to $0.90 on a dollar for those loans. So as that proportion continues to grow, you would expect the overall reserve to grow. I don’t think it would be surprising to see it continue to tick up in line with the other credit metrics through the course of the year.

John Hecht:

Great. That's very helpful. Thanks, guys.

Operator:

Your next question comes from John Rowan of Janney. Your line is open.

John Rowan:

Good morning, guys.

Noah Breslow:

Good morning, John.

Ken Brause:

Hey, John.

John Rowan:

Ken. I'm sorry, I joined late and I caught the tail end of a comment which made me a little confused relative to the answer you just gave to John. When I logged on, you said something about—I thought you were talking about the allowance and you were talking about a release later in the year. Can you clarify what you were talking about — it sounds like we're talking about building the allowance ratio later into the year?

Ken Brause:

Yes. So, I was talking about an allowance just not the allowance for loan losses. I was talking about the valuation allowance on our deferred tax asset. That's about a $38 million valuation allowance which is sitting there on the balance sheet offsetting the deferred tax asset – and what I said is that we would begin to evaluate whether we could do a partial release as we got into the back half of the year.

John Rowan:

That would offset what, cash taxes?

Ken Brause:

It would just come in as an income item. It would be a tax benefit that would flow into book value.

John Rowan:

And then, so the tax rate was higher than you had anticipated. Should we take this current quarter's tax rate as a good run rate going forward?

Ken Brause:

Yes.

John Rowan:

And then just last thing, you remind me, have you launched some of the new products and if so, how is the credit performance on them?

Noah Breslow:

I can take that, John. I mean, equipment finance—we have been piloting with a partner actually. The loans haven't been on our balance sheet, we've just been originating them since the sort of the middle of last year. But as we mentioned in the prepared remarks, we just began to put loans on our balance sheet at the very end of Q1 here. It will be very modest originations this year, but again, we are very encouraged by what we see in the equipment finance opportunity and we have a team sort of building up that products and our capabilities there right now.

Long story short, it's a little bit early there but if you look at the line of credit product where that has come over the last five years, now, I think it's 18% of our loan book. The aim for equipment finance is really to build that up within the next three to five years to be a similar chunk of our business.

John Rowan:

Thank you.

Operator:

Your next question comes from James Faucette of Morgan Stanley. Your line is open.

Steven Wald:

Hey, good morning. It's Steven Wald on for James. Maybe just to start off on the comment you guys made about affirming the net income guidance while the revenues are lower. Maybe if you just if you walk us through some of the levers you see available to pull to get to that target on the expense side?

Ken Brause:

I think with everything, the levers on the expense side are the efficiency of the business and the pace at which we spend on the investments. As we've talked about in the past, we continue to look for opportunities to be more efficient in our core U.S. lending business and making sure that we are spending wisely and we'll continue to manage that to hit our net income targets.

Noah Breslow:

The only thing I would add to what Ken just said is, with a stable NIM as a result of the improvements in cost of funds and a little bit lower originations, you have a mechanical kind of offset but a slightly lower provision expense. We think the combination of those items really drives the consistency and the bottom-line performance.

Steven Wald:

Right. Understood. Thanks. Then separately, I think I heard a comment earlier on the call about the higher applications even though you guys are moving up the credit box and sort of lowering the originations target. Can you maybe talk to—is there's some sort of shift you need to see in terms of who you're mainly targeting with that, would that bring on some incremental cost in terms of shifting if you weren't able to then, over the course of the next few quarters, re-open the credit box?

Noah Breslow:

No, we don't think actually there's incremental cost here. This is really about shaping the portfolio from the application flow that we're seeing. I think as we mentioned in the quarter, we pulled back a little bit on the high-risk part of the equation. We have other moves we can make to better target and better convert the slightly lower risk part of that population. But I think, you know, the fact that applications were a record this quarter is a good sign and continue some of the trends that we saw in 2018. I think it's the secular growth of the space, growing awareness of the OnDeck brand, and the rate of growth of our strategic partner channel which had a record quarter.

Steven Wald:

All right. Perfect. Thanks. That's it for me.

Operator:

Your next question comes from Scott Buck of B. Riley FBR. Your line is open.

Scott Buck:

Good morning, guys.

Noah Breslow:

Good morning, Scott.

Scott Buck:

Good morning. You guys have been fairly successful over the past few quarters, years in reducing the cost of funds. I'm curious, you mentioned Canada but are there any other kind of low-hanging fruit out there to further reduce those in the near term? What's the kind of longer-term outlook for cost of funds?

Ken Brause:

Scott, I'll take that. It's Ken. Thank you for that acknowledgement. I think we're all very pleased and proud of the amount of progress we've made on that front. To be honest, other than our focus on Evolocity and the Canadian opportunity, I wouldn't say there's a lot of low-hanging fruit. I mean, again, when you look at 180 basis point improvement in spread over a year when interest rates have been rising, it's a pretty impressive change in the spreads that we were able to achieve on our facilities.

I think that from this point forward, it'll be continued refinement. Again, I gave the example of the Pioneer's Gate facility that we were able to bring in another 25 basis points. I think there is—we continue to look on the margin, given market conditions, given our portfolio to improve but I don't think we'll see the type of benefit and the improvement that we've seen over the last 12 to 24 months in the next 12 to 24. Obviously, if the interest environment changes, and again we are more liability sensitive to short-term floating rates, so that's an opportunity, if in fact rates declined on the short end.

Scott Buck.

Great. That's helpful. Then in terms of Evolocity in Canada, you mentioned you put some additional cash into the transaction. Could you put some numbers around that or no?

Ken Brause:

We've not giving out the details of the transaction but it's relatively modest and you'll see it in the next quarter's financial statement, so in the range of $10 million.

Scott Buck:

That's helpful. Thank you.

Operator:

Your next question comes from Rob Wildhack of Autonomous Research. Your line is open.

Robert Wildhack:

Good morning, guys. I was hoping to get some more detail on the competitive environment. How would you rate the intensity today relative to the past couple of years? Is the increase in intensity broad-based or coming from more of a specific cohort of competitors?

Noah Breslow:

Hey. This is Noah. I could answer that. Yes, we do think—we sort of said in the last couple of quarters, it was stable. We do think it's a little bit more intense as we saw in the first quarter. I would say it's broad-based, not localized to any one particular competitor. I think you have some larger players in the market that are all getting a little bit more mature, a little bit more scale, some of them are improving their access to capital as well.

Then actually, the small players still have pretty good access to capital, too. Any single one of them is not that big but if you add them altogether, they're sort of equivalently sized to another OnDeck or what have you. That's something that we watch as well. But again, we do think it's pretty rational competition, so it's a little bit different than what we saw back in 2015 and 2016, where we saw people sort of making offers that we didn't really understand. I think that's a good thing overall but definitely, I think the availability of capital in the market and some of the players getting a little bit bigger has resulted in the step-up this quarter.

Rob Wildhack:

Thanks. That's helpful. I know this can be hard to quantify but can you give us a sense for how much you're tightening the credit box here? Is it just a tweak or is it something a little more significant than that?

Noah Breslow:

I think we used the word slightly on the call, so I will say this, when you tighten the credit box, sometimes, there are second-order effects, right? If you tighten and your competitors stay exactly the same, on the margin your funnel's going to deteriorate a little bit, right, because you're not making as aggressive offers as you were before.

But again, we've got a lot of historical data on our portfolio in our trends in the business, so we feel confident in the moves we're making. I think the core OnDeck customer, our sort of credit metrics in the first quarter, our expected loss on the first quarter population is lower than our expected losses on the fourth quarter originations. We're making the right moves, I think, intrinsic to our portfolio and it's not a seismic shift in who we're targeting and what we're trying to do.

Rob Wildhack:

Thanks a lot.

Operator:

Your next question from the line of Vincent Caintic from Stephens. Your line is open.

Vincent Caintic:

Hey, thanks. Good morning.

Ken Brause:

Good morning.

Vincent Caintic:

Just wanted to follow up. Just want to follow up maybe a broad picture of what maybe changed your view in being a little bit more cautious. It seems like you had the guidance change from the last quarter versus this quarter in looking at 2019 with the lower loan growth. But I was wondering if there's anything kind of specific that you see as kind of a macro trends or is this small business environment just getting weaker? You talked about competition, so I appreciate that, but is there anything kind of else you just saw in the quarter that kind of causes you to be a bit more cautious?

Noah Breslow:

Yes. It was, Vincent, really a blend—this is Noah—of kind of three elements, right? Internally, we did see a little bit of weakening in the 2018 vintages. Obviously, we mentioned in the prepared remarks, we had a government shutdown, we had sort of the polar vortex or winter weather issues that happened in January, so that was a real thing for a lot of small business owners.

Then externally, the small business optimism ticking back a little bit. I think a couple months ago, there was a feeling of maybe the cycle was nearer to its end than we feel kind of today, and then you mentioned the competitive dynamic as well. It was really a combination of kind of the internal, the external, a little bit of the competitive.

But again, the other piece of this is that we made a pullback a little bit early in the year, so that's going to flow through our financials and our revenue this year, but we do expect to return to sequential originations growth in the second half of the year. And again, we have a lot of arrows in the quiver to target sort of slightly higher-quality borrowers coming through our existing application funnel.

That's how we're going to kind of play the next quarter or two here, but overall, still very optimistic about the long-term growth prospects of the business and we're just kind of riding the wave a little bit of the economy on what we're seeing internally.

Vincent Caintic:

Got it. That's helpful. Then maybe a little focus on the credit side and if you can just maybe remind me of the seasonality of the business. Your net charge off rate's up 130 basis points year-over-year and delinquency's up 200 basis points. Do you expect that to kind of continue to be the trend for the next couple of quarters this year or is there something, seasonally, that makes second quarter either more or less than what it would be for the rest of the quarters? Thank you.

Ken Brause:

It's Ken, Vincent. I wouldn't describe the credit metrics as necessarily seasonal. They're obviously an outgrowth of what we originate and how they perform. I think I talked about before that the collection strategy and the fact that we are holding more of the late-stage delinquencies which accounted for roughly half of the increase in the increase in the delinquency metric this quarter.

We've got another couple of quarters until that normalizes, so we're going to continue to see that 90 plus bucket grow each quarter and that, obviously, has an impact on the reserve rate required because those are the highest reserved loans on our books because we're essentially taking the loss in P&L. And then what the strategy here is to do better collecting them ourselves rather than to sell them at single cents on the dollar. We think, again, over time, that's going to manifest itself through improved recovery rates which flows back through the system.

Again, we've talked about normalization, we talked about some of the testing we did last year running its way through the system and so you'll see that roll through the DPDs and eventually some charge-offs. But again, I think our message on normalizing to the midpoints of our range over the course of this year is the appropriate way to think about it, not necessarily on the seasonal basis.

Vincent Caintic:

Got it. Thanks very much.

Operator:

Again, if you would like to ask a question, please press star then the number one on your telephone keypad.

Your next question comes from the line of Melissa Wedel from JPMorgan. Your line is open.

Melissa Wedel:

Thanks. Good morning, guys. Just to put a fine point on it. It sounds like you are suggesting that the reserve rate could go incrementally higher through this year?

Ken Brause:

Yes, that's right.

Melissa Wedel:

Okay. Then if you think about the impact of the Evolocity portfolio and anything that you're going to launch on equipment finance, would those be small enough this year that they wouldn't really impact portfolio credit or yield, or do you expect some sort of sizable change?

Ken Brause:

Certainly, equipment finance is small enough that it's not going to be noticeable in the balance sheet or the reserves this year. Evolocity, as we talked about is roughly CAD$50 million portfolio and as we've talked about OnDeck Canada in the past, their loss experience in Canada as in Australia, is lower than in the U.S. So, to the extent it's still a relatively small number and we'll have a very modest impact on the overall credit metrics.

Noah Breslow:
But the impact will be positive.

Ken Brause:

Positive impact, yes, but very modest.

Noah Breslow:

Yes.

Melissa Wedel:

And does that presume that you guys are going to be scaling that beyond sort of the run rate operations or you're just incorporating the existing business?

Noah Breslow:

We're incorporating the existing business but—and there might be a quarter or two we're kind of—we're mostly focused on integration, but no. The plan is to scale that business over the next couple years. With a much bigger team on the ground in Canada, we have largely been supporting Canada from the U.S. with a pretty small team in country.

Evolocity actually had been a little bit constrained by their own balance sheet. And so, by being plugged into the OnDeck balance sheet and our access to the capital, we can actually scale that business faster. I think as we look at 2020, 2021, we mentioned in the call, we see the International businesses turning profitable next year and certainly scaling in those strong double-digit rates for years to come.

Melissa Wedel:

Got it. Thank you.

Operator:

That concludes Q&A and your conference call. Thank you for joining and have a wonderful day.