OnDeck Capital, Inc.

Third Quarter Earnings Conference Call

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David Scharf, *JMP Securities*

Vincent Caintic, *Stephens*

Michael Del Grosso, *Jefferies*

Melissa Wedel, *JP Morgan*

Priscilla Russo, *Morgan Stanley*

PRESENTATION

Operator:

Good morning. My name is Lisa, and I will be your conference Operator today. At this time, I would like to welcome everyone to the OnDeck Third Quarter Earnings Conference 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.

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

Stephen Klimas:

Thank you. Good morning and welcome to OnDeck's Third 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 in the Investor Relations section of our website.

Certain statements, including those relating to our financial guidance for 2018 and outlook for 2019, 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. Our actual results could differ materially and adversely from those anticipated. Today's discussion is also subject to the forward-looking statement limitations in the earnings release.

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 earnings release and the appendix of the earnings presentation posted in the Investor Relations section of 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 an exceptional third quarter. We delivered record profits, business momentum is strong, and we're making good progress in our strategic growth initiatives.

Our core lending franchise, which is the engine powering OnDeck, is hitting on all cylinders. We had record originations in both term loans and lines of credit and we passed a significant milestone, becoming the first online small business lender to exceed $10 billion of cumulative originations in September. Business activity was very high as the quarter's volume growth reflected an increased number of loans and a stable average term loan size. Lending volume from our strategic, funding advisor and referral partner channels continues to build, reflecting growth in our network of partners and alignment between the quality of applications coming in and our risk appetite.

The record originations drove strong portfolio growth of 7% in the third quarter. Year-to-date we have grown our unpaid principal balance of 17%, surpassing our full-year guidance of 10% to 15%.

We also continue to strengthen our credit and risk disciplines. The investments we made in risk management and the steps taken to improve our collection processes are helping to drive strong portfolio performance.

Our charge-off, delinquency and provision rates all improved significantly from a year ago and were in line with the second quarter. Portfolio quality is stable and our strong credit metrics reflect the composition of our portfolio and favorable economic conditions. We continuously enhance our models and credit strategies to improve decisioning, and our platform enables us to be nimble, responding to market opportunities and challenges.

We also improved efficiency on a number of fronts. We improved our balance sheet by refinancing debt at better spreads. We established a new $175 million credit facility and used the proceeds to pay down two facilities at a savings of 425 basis points. In addition to lowering our borrowing costs, we have been successful extending maturities, improving yields on our cash, and increasing operational flexibility with our lenders.

We are also realizing operating efficiency in the core U.S. lending business. Ken will walk you through the details, but operating expenses were down from the second quarter and came in better than our guidance due to the timing of some of our marketing and investment spend. This lower expense, combined with our strong revenue growth, resulted in a 41% efficiency ratio, excluding noteworthy items. That ratio will likely tick up a couple of points next quarter as this quarter's expense level was a few million dollars below our run rate.

Our U.S. lending business has positive operating leverage, but our spending on strategic growth initiatives will accelerate next year, particularly with respect to ODX, and that may lead to a temporary increase in the consolidated efficiency ratio.

Given the strong growth, improved margins and lower expenses, we delivered record top and bottom line results. Specifically, we generated $103 million of gross revenues, $10 million of net income and $13 million of adjusted net income, all of which compare very favorably to the prior periods.

In addition to improving profitability this quarter, we're positioning the Company for long-term success by investing in our strategic initiatives related to international markets, product expansion, and ODX, our Platform as a Service business.

Our international businesses present attractive opportunities and are executing well. International origination volume was up over 50% year-over-year and portfolio quality is better than in the U.S. in terms of both delinquency and credit losses. With the local debt facilities we established in the second quarter, we are funding our international operations more efficiently and we have the capital and liquidity to support their expansion. While the international businesses are not profitable yet, the marginal economics of each loan are very attractive, so it's just a matter of prudently growing the portfolio to get scale.

From a product perspective we continue to broaden our core product offerings and improve our client experience. We introduced slightly longer amortization periods to our line of credit customers which will lower our customers' payment burden and increase utilization. We introduced greater payment flexibility to select term loan clients, enabling us to increase aggregate revenue while helping our clients better manage their cash flow. We continue to expand availability of the instant funding option which has seen strong client adoption.

These types of initiatives are why we consistently receive a strong net promoter score from our clients. Our net promoter score was 84 again in the third quarter and we're still on track to announce our next lending product by year-end.

Finally, we achieved important milestones with respect to our platform-as-a-service offering. First, we formally launched ODX, which was the logical next step in the evolution of what we used to refer to as OnDeck as a Service. For those newer to the OnDeck story, let me remind you of the path that got us here. Initially we had to prove that the online small business lending model could work. We are a pioneer in this sector, and having suppressed $10 billion of total originations, I'd say we did that. We then had to prove a bank and a FinTech company could partner together, as FinTech companies have sometimes struggled to meet the higher regulatory and compliance standards at banks. Our multiyear relationship with JP Morgan Chase has enabled us to do that. With those boxes checked we created ODX to meet increasing demand from banks who want to improve the efficiency and effectiveness of their small business lending franchises by digitizing their application, underwriting, and servicing processes.

We're building out the Leadership Team of ODX and named Brian Geary, a six-year OnDeck veteran, to run the business, and hired Raj Kolluri as the Head of Product and Technology.

We also announced PNC as our second major bank client. We expect to go live with a fully digital PNC small business lending platform in early 2019. Initially, we will power a digital line of credit offering of up to $100,000, and we plan to grow the relationship from there. We have a growing pipeline of banks interested in ODX solutions and plan to announce additional signings next year. We have more conviction in our ability to capitalize on this historic market opportunity than ever.

Before I turn it over to Ken, a few comments on the macro environment. The U.S. economy continues to grow and small business optimism remains high. Demand for our loans is strong despite higher market interest rates and our portfolio is performing well. We don't see any indications of an immediate economic downturn, but we're closely monitoring our portfolio and are prepared to react swiftly if the environment changes.

On the regulatory front, there are calls for increased disclosure at the state level with California and New Jersey leading the way. By creating the SMART Box, we demonstrated that we are a leader with respect to transparency and we are supportive of states working together to develop a national standard. On the federal front, the Treasury and OCC continue to advocate for national charters and voice support for innovators like OnDeck in the lending and capital markets.

Finally, from an opportunity perspective, the SMB lending sector is attractive and remains underserved. Capital continues to flow in, but the competitive environment is largely unchanged from last quarter and pricing remains rational. Every year more and more small businesses are adopting digital lending, and once they try it, they are highly satisfied.

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

Ken Brause:

Well, thank you, Noah, and good morning, everyone. As Noah said, our third quarter performance was very strong across multiple fronts with record earnings driven by strong topline growth and lower-than-expected operating expenses.

Net income was $10 million, or $0.12 per diluted share, compared to $6 million in the second quarter and a net loss of the $4 million a year ago. We improved our return on equity to 14% this quarter, a very respectable level given the low leverage of our balance sheet.

Adjusted net income of $13 million or $0.17 per diluted share increased $3 million sequentially as portfolio growth, improved margins and lower operating expenses more than offset the higher provision for credit losses that was driven by strong originations.

Year-to-date, net income was $14 million or $0.17 per diluted share and adjusted net income was $30 million or $0.38 per diluted share compared to losses a year ago.

Some financial highlights. Gross revenue grew $7 million sequentially to $103 million driven by higher interest income, reflecting growth in our interest earning assets and a higher effective yield. Loan unpaid principal balance grew 7% sequentially to $1.1 billion with term loans growing 6% and lines of credit growing 8%. As Noah said, the portfolio was up nearly 17% from the start of the year, surpassing our full-year guidance of 10% to 15%.

Effective interest yield increased 40 basis points sequentially to 36.5%, reflecting the benefit of prior pricing changes, the mix of new originations and strong portfolio performance. Other revenue was $3.5 million, up slightly from last quarter, reflecting higher ODX revenue. We continue to fund 100% of our originations on balance sheet so there was no gain on sale.

Interest expense decreased slightly from the second quarter to $11.7 million despite a higher average debt balance to fund growth. Our cost of funds rate improved to 6.0% from 6.6% in the second quarter and 6.4% a year ago, as the favorable impact from the lower borrowing spreads on new financings has more than offset the impact of rising market interest rates.

Given the improvements in our effective yield and cost of funds, our net interest margin increased to nearly 33%. That is roughly a full percentage point increase sequentially and a four-point increase from a year ago.

Overall, credit quality significantly improved from last year. Provision expense increased $6 million from the second quarter to $39 million and the corresponding provision rate increased from 5.7% to 6.0%. The dollar increase in the provision reflected the strong origination volume, while the increase in the provision rate to the low-end of our guidance range was driven by the mix of originations, including a slightly higher proportion of loans originated through our funding advisor channel.

The 15-plus delinquency ratio improved to a two-year low of 6.4% and the 90-plus delinquency ratio of 2.4% was unchanged from June 30. The net charge-off rate of 11.1% was flat sequentially and down significantly from a year ago. The allowance for loan losses increased approximately 8% sequentially to $134 million, which was consistent with the quarter's portfolio growth rate. Our reserve ratio increased slightly to 12.2%.

Credit quality remained strong across the portfolio with few signs of weakness. While we're starting to see the impact of higher trade tariffs in some sectors, our exposure to those is immaterial. There was a minimal financial impact from Hurricane Florence in the third quarter and we expect similar from Hurricane Michael in the fourth quarter.

Operating expenses were low this quarter at $43 million, which included just over $0.5 million of debt extinguishment charges related to the facilities we prepaid in August. Excluding debt extinguishment charges in both periods, operating expenses decreased $2 million sequentially, reflecting some temporary declines in sales and marketing and strategic investment spend, along with lower FX-related impacts. Our efficiency ratio excluding net worthy items improved sequentially and from a year ago to 41%, benefiting from both the revenue growth and lower expenses. As Noah mentioned, expenses and the efficiency ratio will likely increase in the fourth quarter as sales and marketing spend normalizes and we invest in technology and analytics related to ODX and other strategic initiatives.

Turning to funding, we continue to have success driving down borrowing costs and improving flexibility. In August we completed a new $175 million facility with Liberty Mutual and Ares Capital. This three-year facility has a coupon of one-month LIBOR plus 300 basis points and will primarily be used to fund lines of credit. We used the proceeds from the new facility to voluntarily prepay two facilities that were priced at one-month LIBOR plus 725. This refinancing effectively reduced our borrowing rate by 425 basis points and extended the final majority over two years to 2022.

Liquidity remains strong with $71 million of cash and equivalents at quarter-end. We also had approximately $225 million of available borrowing capacity within the $1 billion plus of committed debt facilities, and our $30 million corporate credit facility remained undrawn.

OnDeck shareholders equity increased about 5% sequentially to $285 million and our book value per diluted share grew $0.12 to $3.58. Additionally, our debt-to-equity ratio remained stable at 2.8 times.

Given our strong third quarter results and continued business momentum, we increased our 2018 guidance. We're now calling for gross revenue of $392 million to $396 million, net income attributable to OnDeck of $20 million to $24 million, and adjusted net income of $40 million to $44 million. This guidance implies fourth quarter earnings similar to this quarter as we expect a slight increase in revenue from higher average assets to be mitigated by higher operating costs as we invest in our growth initiatives.

We'll provide our 2019 earnings guidance when we release our fourth quarter results but want to provide you with some initial high-level thoughts. In terms of our general outlook, we expect continued strength in originations to result in low double-digit loan growth, a stable net interest margin as lower borrowing spreads mitigate higher market interest rates, and a stable efficiency ratio for the year as positive operating leverage in the U.S. lending business offsets approximately $15 million of incremental investment in our strategic initiatives, including ODX. Underlying this expectation is our assumption that economic, small business and capital market environments remain favorable.

With that, let me turn the call back over to Lisa so we can take your questions.

Operator:

Thank you. 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. We'll pause for just a moment to compile the Q&A roster.

Our first question comes from the line of John Rowan from Janney. Your line is open.

John Rowan:

Morning, guys.

Noah Breslow:

Morning.

Ken Brause:

Morning, John.

John Rowan:

On credit, quickly, you mentioned that you're rolling out longer amortization periods in some of the line of credit products. Can you give us an idea how much longer, what type of impact there'll be on credit or if the longer loan duration changes that typical default period?

Noah Breslow:

Yes, happy to, John. This is Noah. The change is really quite modest in some sense as we're going from six months amortization periods in our line of credit to 12 months amortization periods in our line of credit. It was change that a lot of customers were interested in and we actually think from a payment stress perspective it was sort—it reduces the customer's payment burden and is a good trade. We have a lot of experience in this sub 24-month originations zone so, we feel good about the change overall. We've tested our way into it over the last year and rolled it out more comprehensively this quarter.

John Rowan:

Okay. Just to be clear on guidance, so I think Ken said earnings were going to be similar in the fourth quarter relative to this quarter; correct?

Ken Brause:

That's correct.

John Rowan:

Okay. But the efficiency guidance is for the efficiency ratio to move up in the fourth quarter and then stable next year versus a full year 2018 number or the fourth quarter 2018 number?

Ken Brause:

Versus the full-year 2018 number.

John Rowan:

Okay. Thank you very much.

Ken Brause:

Okay. Thank you.

Operator:

Our next question comes from the line of David Scharf from JMP Securities. Your line is open.

David Scharf:

Yes. Good morning. Thanks for taking my question. Wanted to just better understand the investment spend in ODX, how we're supposed to think about that. I guess specifically, when you provide a figure like $15 million, does that relate to specific startup integration conversion costs for particular lenders that you're going to be partnering with or is that more sort of one-time internal infrastructure to build the business?

Noah Breslow:

Yes, so, David, a couple of points on that. First of all, the $15 million is not exclusively for ODX. ODX comprises about two-thirds of that. A third, though, is related to international and general technology and infrastructure investments we're making next year. So, I would sort of immediately take the $15 million down by a third. Then among the remaining two-thirds, it's sort of split equally between some startup costs for new banks, some general investment from the ODX team and infrastructure we're making, and some new platform and software development work we're doing. I wouldn't try to extrapolate. This is not a giant build for one single bank or anything like that, it's really a balanced set of investments across ODX.

David Scharf:

Got it. Along those lines, I mean, certainly don't need specific contract terms for Chase, PNC and others down the line, but can you talk a little bit about how the revenue model for ODX is unfolding, meaning are most of the contracts—are you getting both an origination and a servicing fee; is every bank you're discussing have sort of a different menu of items in mind that they want you to process for; and also as it relates to startup and conversion costs, some of which is in the $10 million, is there also a licensing component or a cost-sharing component on the part with the bank?

Noah Breslow:

The revenue model does differ a bit between banks, but generally speaking, there is a technology licensing component, there's a professional services or customization component, and then there's a volume-based component. Really, look, our goal is to make our customers successful here. We want these programs grow, we want them to scale. Obviously, there are startup costs that have to be accounted for and borne by the bank. But, really, the long run objective here is to get a number of global banks around the world really scaled up with digital lending programs. If we do that, I think both ODX and our customers will be very successful.

David Scharf:

Got it. Is it fair to conclude that with the professional services component and so on, I mean, you're certainly recapturing some of that investment spend?.

Noah Breslow:

Absolutely.

David Scharf:

Got it. Okay. Terrific. Great results. Thank you.

Noah Breslow:

Thank you.

Ken Brause:

Thank you.

Operator:

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

Vincent Caintic:

Hey. Thanks. Good morning, guys. Just wanted to maybe take a step back on ODX and kind of a big picture, if you can kind of talk about maybe the pipeline there and as you're maybe focusing on ODX, kind of what's the big picture focus when you launched it and where do you think it can go from here, just to start off?

Noah Breslow:

Yes, happy to, Vincent. Thanks for the question. The pipeline, as we said in the prepared remarks, has never been stronger. We did announce PNC this quarter. We've been working on that relationship for over a year. I think you see from the investment spend that we're allocating toward ODX next year, we really believe in the model and the opportunity of helping banks go digital here. I think we're seeing interest both in the U.S. and around the world, so that's sort of a positive surprise, I think. To be frank, I think the announcement of ODX earlier this month really helped catalyze some movement in the market and I think showed people that, not only are we open for business, but we are actively investing in this area, we're building up a Leadership Team. We hired a great Head of Product and Technology for ODX who has 15, 20 years of Software as a Service experience for banks. I think overall we're really committed to the business and we are excited and we expect to announce additional signings next year.

Vincent Caintic:

Perfect. Great. This is something where you expect it to kind of scale up. You had JP Morgan for a while; you just launched PNC; and then so that platform will go live in the first half of 2019. Is it something where it takes about six to nine months to ramp up or is it you could add two banks at a time, four banks at a time? Kind of, I'm trying to see the trajectory of where it can grow.

Noah Breslow:

Yes. I think the trajectory here, we will get better at bringing banks on. I think we've already seen that as we brought PNC on versus maybe the original experience with Chase. I expect as we bring on subsequent banks, to improve on that as well. I think we're developing repeatable models for doing this. That being said, each bank is unique and requires certain customization, so it's not a perfect build every time. But on the flip side, we should get better at it over time.

Ken Brause:

Vincent, this is Ken. We can't control the decision-making process at our clients, so we're out there working the pipeline and the timing of when we get the go, and how many goes will determine how we get on-boarded and what timeframe.

Vincent Caintic:

Okay. Perfect. Then just the last one for me, when you just kind of compare the ODX platform versus your on balance sheet lending, kind of I guess how will each of those two businesses evolve over time, is it kind of complementary, is there, I don't know, some cannibalization, or how do you kind of think about those two businesses and how they work together? Thank you.

Noah Breslow:

No. They're very complementary because banks' risk appetites are not changing. Actually, when we announced PNC a few weeks back, PNC was very clear about that. They are trying to serve the same level of risks that they've always been serving; they're just trying to do it in a digital way. OnDeck historically has focused on a more underserved population of small business owners, so we view the market that OnDeck's lending business serves as complementary to banks. There is the possibility over time that even businesses that banks are unable to serve themselves could be referred over to OnDeck's lending business. Overall, we view the business as quite complementary.

Vincent Caintic:

Perfect. Thanks very much.

Operator:

Our next question comes from the line of Mike Del Grosso from Jefferies. Your line is open.

Michael Del Grosso:

Good morning and thank you for taking my questions. Congrats on a strong quarter. I had a question on the originations which were higher than we had forecasted. Could you talk about the composition or, I guess, the channel of the new loans; is this mostly demand from new customers or how do you attribute the strong growth this quarter? Thanks.

Ken Brause:

Hey, sure, Mike. It's Ken. We were very pleased with the volume and the demand. Obviously, the market demand is there and I think in terms of our particular originations we saw good volume both from new customers as well as renewals, and within the new customers, strong volume from our partner channels. Overall, I think we were pleased that we saw increased website traffic leading to higher applications. Again, I talked about growth, both in the term loan and the LOC product, so very pleased overall. I think it was a broad-based increase of both new and renewal.

Michael Del Grosso:

Okay. Great. Then I guess a follow-up on, I guess, the provision rate in the context of kind of a longer-term cycle. Credit metrics this quarter were also particularly strong, but when I think about that long-term, do you think that 6% to 8% provision rate is a good longer-term target or how do we think about that in the context of the cycle? Thanks.

Ken Brause:

It's Ken again. Actually, our guidance has been 6% to 7% on the provision rate and we've been at the lower end of that range. I think with any credit metric, obviously it's dependent upon where we are in the economic cycle and on our risk appetite. I think at this point in time we think that is an appropriate range, but, as I mentioned, we'll give more clarity on our 2019 formal guidance on the next earnings call.

Michael Del Grosso:

Great. Thanks and congrats on the good quarter.

Ken Brause:

Thanks again.

Operator:

Again, if you'd like to ask a question, that's star, one on your telephone keypad. Our next question comes from the line of Melissa Wedel from JP Morgan. Your line is open.

Melissa Wedel:

Great. Thanks, guys. Question about the reserve ratio; we've seen charge-offs and credit generally improving for the last few quarters, but there's been really slow build in the allowance reserve ratio. I'm wondering if that's something that we should expect to continue to see or if we might be at a stable base rate at this point.

Ken Brause:

Sure. It's Ken, Melissa. Good morning. I think compared to a year ago there's certainly been a build in the reserve ratio. I think if you look sequentially, 10 basis points, I generally consider pretty flat in that ratio. I think we talked in the past about our collections strategy changing to hold more and work out more of our 90-plus loans. We've seen that change take place which has caused an increase in reserves held against those loans while we work them out, as opposed to sell them. Again, as I said in my guide, it's hard to predict the risk in the portfolio not knowing what the economy will be like in the future, but I think the level that we're at today you might see some variability quarter-to-quarter, but I think it's an appropriate level for the risk in the portfolio and today's environment.

Melissa Wedel:

Okay. Thanks. A follow-up question; I'm curious what you guys are seeing in terms of debt trends with your underlying customers. When you kind of look through balance sheets, are you seeing an increase in overall debt or are things pretty stable? Thanks.

Noah Breslow:

Right now things are pretty stable actually. Remember, we're in more the commercial small business space. Our customers are typically seven, eight years in business and, call it, $600,000 in annual revenue. From a commercial perspective, no, the small business optimism is really near the all-time highs and their access to capital, we don't see them as being increasingly levered at this point in the cycle.

Melissa Wedel:

Thank you.

Operator:

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

Priscilla Russo:

Hi. This is Priscilla in for James. Last quarter you indicated that the effective interest yield had largely been, that the pricing change has largely been captured in that metric, but this quarter it ticked up again. I know you mentioned some mix. Can you just go through that a little bit more and whether you think that this 36.5% is where it's going to stabilize?

Ken Brause:

Sure. Good morning, Priscilla. It's Ken. There are many factors that drive the effective interest yield, both the mix in terms of term versus line of credit, the channel of the customers, and we did talk about the fact our funding advisor partner channel was strong, which tends to have some higher yields and APRs, as well as the duration of the loan, which will increase also the effective interest yield, not to mention the performance of the portfolio, so the lower-level of delinquencies leads to a higher effective interest yields, and if you saw those metrics, they actually are improving as well.

Again, I hate to sound like a broken record, it's hard to predict how all those factors will move in any given quarter, so I do think it's fair to say that the level we're at, again, with some potential movement up or down, minor changes as appropriate and we'll continue to manage that going forward and look for the best outcome.

Priscilla Russo:

Makes sense. Then in terms of Other revenue, it's still roughly flat from last quarter, so is that still related to the JPM slow down and when do you think that will get better?

Noah Breslow:

Yes. This is Noah. As we discussed in the last call, there was some regulatory changes that we had to make to the JP Morgan program that caused a slowdown in volume. Happy to report that those volumes are now kind of back to normal as we exited the third quarter and headed into the fourth quarter here. We expect a strong quarter for the JP Morgan program going ahead, but, again, we can't comment specifically on actual volume levels.

Priscilla Russo:

Great. Thank you.

Noah Breslow:

All right. Thank you very much.

Operator:

We have no questions in queue. I will turn the call back over to the presenters.

Noah Breslow:

Okay. Thank you, Lisa, and thank you all for joining us today. In closing, 2018 is shaping up to be a transformative year for OnDeck. We turned the corner on profitability; we're prudently growing our cornerstone lending business; we launched ODX to meet demand for our Platform as a Services solutions; and we are further advancing our funding profile and risk management discipline. Our 2018 results are far exceeding the guidance we laid out in the beginning of the year and we are confident the path we are on, the investments we're making are positioning OnDeck for growth and even greater value creation in the years to come. Thanks, everyone. Have a great day.

Operator:

This concludes today's conference call. You may now disconnect.