Operator

Welcome to Oportun Financial Corporation's Third Quarter 2022 Earnings Conference Call. All lines have been placed on mute to prevent background noise. After the speakers' remarks, there will be a question-and-answer session. Today's call is being recorded. For opening remarks and introductions, I'd like to turn the call over to Dorian Hare, Senior Vice President of Investor Relations. Mr. Hare, you may begin.

Introduction: Dorian Hare, Senior Vice President, Investor Relations

Thanks, and hello everyone. With me to discuss Oportun's third quarter 2022 results are Raul Vazquez, Chief Executive Officer, and Jonathan Coblentz, Chief Financial Officer & Chief Administrative Officer. I'll remind everyone on the call or webcast that some of the remarks made today will include forward-looking statements related to our business, future results of operations and financial position, planned products and services, business strategy and plans and objectives of management for our future operations. Actual results may differ materially from those contemplated or implied by these forward-looking statements, and we caution you not to place undue reliance on these forward-looking statements. A more detailed discussion of the risk factors that could cause these results to differ materially are set forth in our earnings press release and in our filings with the Securities and Exchange Commission under the caption, "Risk Factors," including our upcoming Form 10-Q filing for the quarter ended September 30, 2022. Any forward-looking statements that we make on this call are based on assumptions as of today, and we undertake no obligation to update these statements as a result of new information or future events other than as required by law.

Also on today's call, we will present both GAAP and non-GAAP financial measures, which we believe can be useful measures for the period-to-period comparisons of our core business, and which will provide useful information to investors regarding our financial condition and results of operations. A full list of definitions can be found in our earnings materials, available at the investor relations section on our website. Non-GAAP financial measures are presented in addition to and not as a substitute for financial measures calculated in accordance with GAAP. A reconciliation of non-GAAP to GAAP measures is included in our earnings press release, our third quarter 2022 financial supplement and the appendix section of the third quarter 2022 earnings presentation, all of which are available at the investor relations section of our website at investor.oportun.com. In addition, this call is being webcast, and an archive version will be available after the call, along with a script of our prepared remarks. With that, I will now turn the call over to Raul.

Raul Vazquez, Chief Executive Officer

Thanks, Dorian and good afternoon, everyone. Thank you for joining us. Today, I'd like to discuss our third quarter financial performance, followed by an update on how the macroeconomic environment is impacting Oportun and its members, and close with an update on our strategic initiatives.

Oportun delivered a strong, profitable third quarter on an adjusted basis. Let me start with the following summary:

- We delivered revenue of $250 million, up 57%, along with adjusted net income of $8.4 million, for adjusted EPS of $0.25.
- Our annualized net charge-off rate of 9.8% was in line with our prior guidance.
- And, we're upwardly revising our full-year 2022 revenue and adjusted EPS guidance.

Let me now update you in more detail regarding what we saw in Q3, starting with credit. Credit is the most important metric in our business. On our prior earnings call, we shared that starting in July, we had initiated a set of actions, including significantly tightening our underwriting standards, to address the impact of inflation on our members. I'm pleased to inform you that these actions are having their intended effect:

- We're continuing to reduce our exposure to new borrowers and increase our proportionate exposure to more profitable, returning borrowers, who have already successfully repaid at least one loan to Oportun. In the third quarter, 28% of our loans were to new borrowers as compared to 44% in the second quarter and 51% in the first quarter.
- Early-stage delinquencies are trending downward. For instance, from July to September, our 15-29 day delinquencies declined from 2.1% to 1.8% and our 30-59 day delinquencies declined from 2.2% to 2.1%. These trends defy the usual seasonal patterns in delinquencies, which typically rise in the back half of the year;
- And our first payment defaults are now below 2019 pre-pandemic levels, having come down from the 2% range to below 1%.

So in summary we're very pleased with the credit results from Q3 originations and are setting ourselves up well for good credit performance in 2023.

Now I'd like to update you on the other actions we've been taking. Starting with underwriting:

- We're introducing and leveraging new underwriting models that have and will continue to significantly improve our credit performance. For instance, we launched an updated version of our model specifically focused on underwriting our returning portfolio. We are also expanding the use of the bank transaction model we launched earlier this year by giving more applicants the opportunity to share their data, providing a more complete snapshot of their current financial situation.

- We also launched a new direct marketing platform this quarter that we expect will be fully implemented by the end of the year. We expect this new platform to improve the risk levels of the direct mail program and enable additional digital channels where we will be able to target customers based on their credit profile.

Our funding and liquidity remain strong, and in September we bolstered them by raising additional capital, with a new four-year $150 million senior secured term loan. The investment community's confidence in Oportun was also just further validated by our closing last week of our fourth securitization of 2022. Our ability to complete these financings increases our capacity to fund future originations.

Finally we've made progress and continue to focus on a significant reduction of operating expense growth. We are reiterating our mandate for flat second half Adjusted Operating Expenses versus the first half of the year by reducing sales and marketing costs and limiting headcount growth. As a proof point of achieving this objective, third quarter Adjusted Operating Expense declined 3% sequentially, defying our typical seasonal trends, and Adjusted Operating Efficiency improved by approximately 1,300 basis points year-over-year to 54%, our lowest level since our 2019 IPO.

As you can see, we continue to take the necessary steps towards putting the company on the strongest possible footing, and are committed to limiting expense growth in order to operate more efficiently in 2023.

Shifting now to our long-term strategic priorities, let me update you on our progress on enhancing our platform capabilities, growing our members and increasing our multi-product relationships.

We're continuing to enhance our platform capabilities to meet the everyday financial needs of hardworking people. We are on track to start testing our Unified App this quarter that brings together all the Digit saving, banking, investing products and Oportun credit products into a single mobile application. Digit's financial performance is exceeding our expectations and our overall integration continues to progress nicely.

We ended the third quarter with 1.9 million members up from 1.8 million at the end of last quarter, a 9% annualized growth rate. We are pleased with this pace of adding high-quality new members to Oportun, given our lower marketing spend and decreased focus on acquiring new borrowers.

Furthermore in the third quarter, products grew at an annualized rate of 11%, faster than our member growth of 9% as members continued to increase their engagement with Oportun.

Now, let me update you on new product activities. As a reminder, we indicated on our prior earnings call that we would deliberately moderate growth in our secured personal loan and credit card products in the second half of this year, as part of our credit tightening actions.

- For our secured personal loan product, we ended the third quarter with $116 million in receivables, up from $100 million sequentially.

- Our credit card receivables grew at a similarly moderate pace to $131 million, up from $119 million sequentially. We now have more than 200 thousand members who have an Oportun branded credit card.

Finally, we have also continued to make great progress with our lending-as-a-service partner channel, from which we can efficiently increase our applicant pool and selectively add high-quality new members even while we tighten our credit standards. During the third quarter, we scaled our partner network to include 348 locations, up from 229 a year ago, and we still expect to complete 2022 with over 500 locations. Additionally, our partnership with Sezzle, a Buy Now, Pay Later company and our first digital LaaS relationship, remains on track to launch this quarter.

With that, I'd like to turn it over to Jonathan for additional details on our financial performance and our revised guidance. He will also take you through a technical accounting requirement that caused a non-cash $108 million write-off of goodwill, that impacted our Q3 GAAP results.

Jonathan Coblentz, Chief Financial Officer & Chief Administrative Officer

Thanks, and good afternoon everyone. As Raul mentioned, we're pleased with our third quarter results, which exemplify the resilience of Oportun's business model under the current macroeconomic environment.

In the third quarter, we generated $250 million of total revenue and $8.4 million of Adjusted Net Income, or $0.25 of Adjusted EPS. Revenue upside and expense discipline enabled us to be profitable, while our prior guidance had indicated the expectation for a slight loss.

Our aggregate originations were $634 million, down 4% year-over-year and modestly below the prior guidance of between $650 and $675 million for the quarter. This reflects the credit tightening actions we initiated in July, and our focus on high-quality originations.

Total revenue of $250 million was above the guidance range and up 57% year-over-year, with upside reflecting lower than anticipated prepayments. We expect continued revenue growth in to 2023, even as we keep to tighter underwriting standards.

Net revenue was $147 million, up 5% year-over-year. Net revenue improved from the prior year period due to higher total revenue, partially offset by higher interest expense and net charge-offs as compared to last year.

Interest expense of $27 million was up 152% year over year, primarily driven by increased debt issuance to fund our growth, and the increase in our cost of debt to 3.9% versus 2.8% in the year-ago period. At the end of the third quarter, 79% of our debt was fixed rate, providing us with protection from rising interest rates.

For our net change in fair value, we had a $76 million net decrease, which consisted mainly of current period charge-offs of $72 million.

For the mark-to-market, the fair value price of our loans decreased to 100.7% as of September 30, and resulted in a $41 million mark-to-market decrease.

The $61 million mark-to-market increase in our asset-backed notes resulted from a 181 basis point decrease in the weighted average price to 92.9%, due to the increase in interest rates and credit spreads during the quarter.

Turning to expenses, we maintained strong expense discipline as we said we would on our prior call with Adjusted Operating Expenses decreasing sequentially 3%. As Raul mentioned, we will continue to reduce our Adjusted Operating Expense growth rate going forward and are on track to be flat in the second half versus the first half of the year.

Our customer acquisition cost was $142, down 7% from the prior-year period due to lower direct mail and online marketing expenditures, partially offset by lower aggregate originations.

We delivered adjusted net income of $8.4 million, compared to $24 million in the prior-year quarter, and adjusted EPS of $0.25 versus $0.78, respectively. For the first three quarters of the year combined, adjusted net income was $65 million, representing 23% year-over-year growth, and adjusted EPS was $1.95, representing 11% year-over-year growth.

As Raul mentioned, our GAAP results were impacted by a technical accounting requirement. Because our market capitalization remained below our tangible book value, we were required by GAAP to write off $108 million of goodwill. Our GAAP net income and EPS were impacted by this non-cash charge. While the goodwill related to our acquisition of Digit, the write-down is not a reflection on Digit's financial performance, which as you heard Raul mention earlier is exceeding our expectations. We have not impaired any of the other intangibles we acquired with Digit for this reason. Because this was a non-cash charge, it in no way effects the operations or future prospects of the company.

Adjusted EBITDA was a $6.2 million loss in the third quarter, a $24 million decrease compared to a gain of $18 million in the prior-year quarter. For the nine months of the year, adjusted EBITDA was $23 million, flat to the prior year period.

Adjusted Return on Equity was 6%, versus 19% in the prior-year quarter. For the last twelve months, Adjusted ROE averaged 17%.

Turning now to credit, our third quarter results showed we managed our credit well to deliver outcomes in line with our prior guidance. Our annualized net charge-off rate was 9.8%, compared to 5.5% in the prior-year period. As a reminder, last year's charge-off rate was abnormally low due to strong consumer balance sheets including the impact of government stimulus amidst the pandemic. As of September 30, our 30+ day delinquency rate was 5.4%, which was consistent with the increased charge-off trends we previously guided to.

Regarding our capital and liquidity, as of September 30, total cash was $272 million. Additionally, net cash flow from operations for the third quarter was $68 million, up 44% year over year. Our Debt-to-Equity ratio was 5.2x, and absent the impact of the non-cash goodwill impairment charge I just discussed, our debt to equity ratio would have been 4.3x. Also as of September 30th, $382 million of our combined $750 million in warehouse lines was undrawn and available to fund our growth. We're well-positioned to maintain our strong liquidity while we selectively underwrite high-quality loans in our tightened credit posture.

We have maintained our track record of consistent access to the capital markets. Raul mentioned that we closed a four-year $150 million Senior Secured Term Loan in September. It’s important to emphasize that this new facility provides non-dilutive capital that supports the continued investment and growth in our business that we expect in 2023 and beyond, even under the tighter credit underwriting criteria we have adopted in the current environment.

We also just closed our fourth securitization of 2022, a $300 million asset backed note issuance, reaffirming our access to funding and investor support for our business model.

Turning to our expectations for the rest of 2022, we remain focused on prudent, profitable growth, by tightening credit and continuing the cost discipline that Raul mentioned.

In terms of guidance, our outlook for the fourth quarter is:

- Aggregate originations of $650 to $700 million;
- Total Revenue of $255 to $260 million;
- Adjusted Net Income of $8 to $10 million; and
- Adjusted EPS of $0.24 to $0.30

Our updated guidance for the full year is:

- Aggregate originations of $2.962 to $3.012 billion;
- Total Revenue of $946 to $951 million;
- Adjusted Net Income of $73 to $75 million; and
- Adjusted EPS of $2.19 to $2.25

Going forward, our credit performance will be driven by two different portfolio dynamics: the loans we've been originating since July under significantly tighter credit standards and the loans originated prior to that.

- Let me start with the loans we've originated since July. The credit tightening is already having the desired effect of driving down our early-stage delinquencies and first payment defaults, with performance trending better than 2019. You can see these trends in the additional slides we've included in our earnings presentation this quarter.
- With regard to the loans originated prior to July, the charge-offs we expect to have in the fourth quarter will be almost entirely from these loans we originated prior to tightening.

For the fourth quarter, we are guiding to 11.9% annualized net charge-offs, plus or minus 25 basis points. For the full year, we are increasing our guidance by 30 basis points to 9.9% net charge-offs plus or minus 20 basis points.

- Approximately 12 basis points of the increase in rate for the full year is reflective of the denominator effect of credit tightening leading to reduced origination amounts and lower average daily receivables from our prior expectation.
- It's worth keeping in mind that this upward revision of full year guidance only represents $8 million more in charge-offs than previously expected. And, even after these expected incremental charge offs we are forecasting $8 to $10 million in adjusted income for the fourth quarter.
- Additionally, because the average life of our portfolio is only 0.92 years, the portfolio will turn over more than once per year. This means that the loans we started originating under tighter credit standards in July will make up the vast majority of the portfolio by the second half of 2023.

While we expect to have elevated loss rates into the fourth quarter of this year, our projection remains that losses will start decreasing in the first quarter of 2023 and return to our target 7 to 9% range by the third quarter of 2023.

In summary, I'm pleased that we delivered another strong quarter, Oportun's 9th consecutive profitable quarter, and that we are in a position today to upwardly revise our 2022 profit outlook.

With that, I will now turn it back over to Raul for some final comments before we open the line for questions.

Raul Vazquez, Chief Executive Officer

Thanks, Jonathan.

This quarter exceeded our expectations and I am confident that we will emerge from this challenging economic environment a stronger company than ever before, just as Oportun did following the pandemic and the financial crisis. The resilience the company has and will continue to exhibit reflects the determination of our talented employees.

Oportun will continue to deliver responsible, profitable growth on behalf of our shareholders. I look forward to reviewing our fourth quarter results and providing our outlook on 2023 when we next report in February.

With that, Operator, let's open up the line for questions.

[Question & Answer Session]

Conclusion: Raul Vazquez, Chief Executive Officer

Thanks again for joining us on today's call. We look forward to speaking with you again soon.