FlexShopper, LLC
Q3 2020 Earnings Call
November 10, 2020

<u>Presenters</u>
Jeremy Hellman - The Equity Group
Richard House - CEO
Harold Russell Heiser - CFO
Brad Bernstein - President and Co-Founder

<u>Q&A Participants</u>
Michael Diana - Maxim Group

Operator
Greetings and welcome to FlexShopper's Q3 2020 Earnings Conference Call. At this time, all participants are in a listen-only mode. A question-and-answer session will follow the formal presentation. If anyone should require operator assistance during the conference, please press star zero on your telephone keypad. Please note this conference is being recorded. I would now like to turn the conference over to your host, Jeremy Hellman of the Equity Group. Thank you. You may begin.

Jeremy Hellman
Thank you, operator. I would like to remind everyone that we have posted an updated investor presentation within the IR section of the company website, www.flexshopper.com, and encourage everyone to review the forward-looking statement on page two of the presentation. With that, I would like to turn the call over to FlexShopper's CEO, Rich House. Please go ahead, Rich.

Rich House
Thank you, Jeremy, and welcome, everyone, to our earnings call. Joining me today is Russ Heiser, our CFO, and Brad Bernstein, the founder and President of FlexShopper. This morning, Russ will be expanding on the key financial aspects of our quarterly results, and Brad will provide an update on our business to business partnership operations. I will conclude with a summary of our current strategy and a few other key points.

Prior to handing the call over to Russ, I would like to highlight some of the key points regarding our business in the third quarter. Most importantly, our credit quality continues to be favorable. This result has been particularly important as the government financial stimulus, which was prevalent earlier in the year, has certainly diminished. You may recall from the last two earnings calls, we had tightened our underwriting standards as a precaution against potential unfavorable economic activity. However, we also continue to test across the credit spectrum in a prudent manner. As a result of that continued testing, I'm happy to report we were able to significantly accelerate our marketing beginning in mid-August. We are seeing very robust levels of growth in our lease volume, which is the key driver of our future profitability. Russ will provide more detail around this growth in his comments.

Our online B2C marketplace, flexshopper.com, has operated even better than we anticipated in the third quarter. We attribute this improved performance to a combination of three events: the general shift in consumers preference for e-commerce, a continued improvement in the sophistication of our digital marketing algorithms, and the expansion of marketing investments in new digitally based marketing channels from sources that we had only been testing in the past. The combination of these three factors enabled us to enjoy significant lease volume growth in August and September. We believe that growth in the direct to consumer channel will continue moving forward.

With respect to our retail partnership business, it was recovering in the third quarter from the second quarter slowdown that occurred due to shelter-in-place restrictions. Fortunately, we added a new partner that was focused on e-commerce solutions, and that made up for much of the relatively lighter volume with our brick and mortar customers. Brad will add some more color on this line of business later in the call. Now, I'll hand over this call to Russ to discuss the financial highlights.

Russell Heiser
Thanks, Rich. I'm going to start with a reminder that we have posted an updated investor deck on our website. Investor deck has some additional details which we think are helpful in understanding our business and together with our press release and 10-Q provide significant insight into our third quarter operating performance.

Adding to Rich's opening comments regarding our market testing and subsequent business activity, it is important to note the FlexShopper has years of customer data, enabling us to perform detailed analytics upon which we base our operations. Furthermore, the vast majority of our customers pay weekly, enabling us to obtain quick feedback on their performance. This combination of abundant historical data and short feedback cycles served us well during the pandemic allowing us to make informed decisions quickly. In Q2 and into early Q3, the test data demonstrated that even our lowest scoring customers, and therefore likely the riskiest customers, were performing. However, in an abundance of caution, we waited a few more weeks to observe performance after the curtailing of enhanced unemployment benefits before returning to pre-COVID approval rates in mid-August.

The same time that we opened up approval rates, we increased our B2C marketing spend. Digital marketing has become a core competency at FlexShopper over the last year. It is a key aspect of our business and a tool which we think we use very efficiently as evidenced by our average customer acquisition cost staying relatively flat despite increased marketing expenditures. The combination of returning to pre-COVID approval rates and disciplined marketing spending in the last six weeks of the third quarter led to a significant increase in lease originations, with September becoming the highest non-holiday origination month for the B2C channel in company history. Overall, our third quarter gross origination volume was up 33% to 22.7 million over the same quarter last year. Underpinning that was an increase of 30% in leases to over 47,000 and a modest increase of 2.5% in average origination value to $480. Those of you who have followed us for some time will understand that current period originations are highly predictive when it comes to forecasting revenues over the ensuing year, since we recognize the lease revenue over the term of the lease.

In addition, I want to also highlight the net lease merchandise line on our balance sheet. The lease merchandise line represents actual merchandise that has been leased by customers, net of accumulated depreciation, and any impairments. This is a good representation of the size of the performing lease portfolio and, as such, is also highly correlated with forward 12 months revenue and gross profit. We've added a page to our investor presentation this quarter showing lease merchandise over time. As that data shows, due to a combination of decreases in B2B originations caused by COVID and the prudent approach to B2C marketing spend and underwriting that we've discussed since the end of Q1, the lease portfolio didn't grow as much as we would have liked from mid-March until mid-August. That was a temporary low (sp), though. As I mentioned, the last six weeks of the quarter were terrific for the B2C or flexshopper.com portion of the business and the B2B segment rebounded well as Brad will cover in more detail. At the end of the third quarter, net inventory stood at almost $31 million, which is up 26% from the same time last year, and positions us well going into our fourth quarter.

Gross profit margins increased to 36%, which was up nicely from the 30% in the second quarter, which had experienced margin compression due to an increase in early payoff transactions, which we believe were a byproduct of government stimulus. Third quarter gross margins were relatively consistent with last year’s 37%, so we think it is reasonable to conclude the rate of early payoff transactions has returned to a more normal level at this point, although that could always be impacted again by additional government stimulus. Marketing expense is 1.7 million in the third quarter, which is a significant increase versus the 900,000 from the third quarter of 2019. As I noted, our data provided the justification for onboarding these new customers as long as it can be done at the appropriate acquisition cost. Marketing spending is responsible for driving growth in the lease portfolio in the short-term, and the long term is what grows revenue and gross profit.

New customer acquisition cost for the quarter came in at $77. This is about 13% lower than last quarter. In addition, the new customer acquisition costs for both B2C and B2B are (inaudible) lower but comparable to the first quarter of the year. However, the mix of customers by channel have (inaudible) the first quarter as a result of the COVID environment. EBITDA was 2.1 million for the third quarter compared to 3.2 million in the third quarter of 2019. The largest item driving this year-over-year change in EBITDA was the marketing expense increase of approximately 800,000, which I previously noted.

The other additional upfront variable costs associated with new originations is the underwriting cost. This is the data that is purchased and examined on each consumer as part of the underwriting decision. That cost is approximately $300,000 higher in this quarter versus a year ago as a result of the growth in originations. Therefore, the 1.1 million difference in EBITDA between periods was all spent on growing the lease. Now, I'll hand it over to Brad for an update on the B2B business.

Brad Bernstein
Thank you, Russ. Since our last call, existing retail partner originations continued to rebound and are closer to pre-COVID-19 levels. More importantly, the addition of new retail partners and the rebounding and optimizing of existing retail relationships made September our largest B2B lease origination month since inception. So, as Russ had mentioned, September was our largest B2C lease origination month. We also had our largest B2B lease origination month in September. We continued to turn retail prospects into partners with successful adoption of our mobile LTO technology, of course, different product categories. Examples this last quarter include two regional retailers, one in furniture and another in electronics, that we're able to launch quickly with our turnkey mobile app solution. As most of you know by now, our in store payment solutions required no integration with the retailer and are quick and seamless for consumers and store employees. Our innovative technology at the point of sale and no money down lease-to-own payment option make our retailer proposition very compelling.

We are also very focused on maximizing existing accounts. I'm pleased to share that the e-commerce account we spoke of on the last call that is currently at an annualized multi-million dollar run rate has exceeded our expectations. In addition, with local field support and collaborative marketing initiatives, we continue to optimize an exciting 23 store pilot that we started in the second quarter. This retailer also diversifies our category base and sells a variety of merchandise from electronics to bikes to musical instruments. There's no doubt that the COVID crisis has accelerated adoption of e-commerce, so we are very focused on marketing our seamless online lease-to-own payment method of checkout to e-commerce sites.

Another beneficiary of online acceleration is flexshopper.com, which makes FlexShopper's omnichannel offering more compelling than ever to retailers looking to broaden their customer base and increase sales with consumers short on cash and credit. We currently are the only virtual lease-to-own provider that has this omnichannel ecosystem comprised of an online marketplace, lease-to-own e-commerce payment method, and in store LTO payment solution for retailers and consumers. We're very bullish about our pipeline and excited about our product offering as we continue to penetrate the significant virtual lease-to-own market opportunity. And now, I'd like to turn the call over to Rich.

Rich House
Thank you, Brad. Since I arrived at the company a little over a year ago, we have emphasized our core priorities, which are underwriting, liquidity, and distribution. In good times and bad these elements enable us to maximize our return on shareholder's capital. Although the COVID-

19 phenomenon slowed us down some, we can now add growth to the topics we would like to discuss moving forward. Looking back over the period from beginning of the year till now, we have not seen any degradation in our credit quality. Additionally, we are far more confident with the breadth of our marketing sources and can see a clear path of growing our direct-to-consumer business.

Finally, we are having new success in our retail partnership, or B2B channel, and we anticipate growth there, as well. In addition to our marketing success and obtaining new (sp) consumers, importantly, we continue to see improvement in our repeat lease volumes. We believe this is due to a combination of better underwriting, which, of course, gives us more consumers to market to over time, and additional sophistication in the segmentation and stimulation of our existing customer base. Earlier, Russ pointed out a couple of key metrics to observe when looking at our future earnings outlook. In the long term, it is going to be the net lease merchandise level, which has increased by 26% year-over-year. In the shorter term, there's always a bit of an earnings drag based on our marketing investments. That is to say, the immediate expenses associated with marketing and underwriting offset the revenues provided by leases generated in previous periods. The good news is that, over time, the larger than net lease merchandise level of the company, there is less of an earnings drag based on marketing investments. This is due to the earnings power that is created by higher inventory levels. Higher sustained net lease merchandise levels is what drives the scalability of the company, and we believe we have now established the platform to achieve scalable and profitable growth moving forward.

Of course, we continue to operate in a tumultuous economic and political environment. While we are pleased with where we are currently with respect to our risk and marketing initiatives, it is still difficult to have long-term visibility with the U.S. economy. I am certainly no more qualified than anyone else to predict if there will be another surge in COVID-19 cases, if there'll be another national shelter-in-place initiative, or if there will be further government stimulus payments for consumers. However, we are more confident in how we can respond to any of these events now. Another shelter-in-place initiative would obviously slow our brick and mortar retail partnership business. On the other hand, based on the hearings we've had over the last eight months, we are (inaudible) continuing to aggressively invest in marketing and in our online and e-commerce partnership channels. Another stimulus package is probably favorable for our business, but we have seen that it is not necessary for us to establish the appropriate returns on our invested capital. That concludes our prepared remarks, and we're happy to take any (sp) questions at this time.

Operator
At this time, we will be conducting a question-and-answer session. If you would like to ask a question, please press star one on your telephone keypad. A confirmation tone will indicate your line is in the question queue. You may press star two if you would like to remove your question from the queue. For participants using speaker equipment, it may be necessary to pick up your handset before pressing the star keys. One moment, please, as we pull for questions.

Our first question comes from line of Michael Diana with Maxim Group. Please proceed with your question.

Michael Diana
Hi. Brad mentioned your 23 store pilot program that you started in the second quarter. Did that contribute in the third quarter, or is that—or is the main contributions still yet to come?

Richard House
Brad, I will let you handle that.

Brad Bernstein
Yeah. Mike, how are you? That—it is contributing in the third quarter, yes.

Michael Diana
Okay, good. But not to its full extent or?

Brad Bernstein
No, it was a very small contribution as it was part of the pilot program. We are looking forward to that increasing over time, but it was actually contributing but at a very small level.

Michael Diana
Okay. Great. Thank you.

Operator
And once again, if you would like to ask a question, please press star one on your telephone keypad. Once again, if you would like to ask a question, please press star one on your telephone keypad. One moment, please. There seems to be no further questions left in the queue. And with that, I would like to turn the call back over to Rich House for any closing remarks.

Rich House
Well, thank you, everyone, for joining us, and we will look forward to speaking with you again at our year-end earnings call, and thank you again for joining us.

Operator
This concludes today's teleconference. You may now disconnect your lines at this time. Thank you for your participation and have a wonderful day.