Research - On Deck Capital (5/6/19)

Description: On Deck Capital, Inc. operates an online platform for small business lending in the United States, Canada, and Australia. It offers term loans and lines of credit. The company also provides technology and services platform that facilitates online lending to small business customers for banks. It distributes its products through direct marketing channel, strategic partners, and funding advisors. The company was founded in 2006 and is headquartered in New York, New York.

Ticker: ONDK
Price: $4.73
Market Cap: $359M
Performance: -19.8% YTD

Analysis

On Deck Capital hasn't just been having a rough 2019 underperforming the market by approximately 38%, they've also been having a rough time as a public company down from their debut at $20 per share back in late 2014.

The company is in a pretty competitive space with their most prominent peers being Kabbage, LendingClub (LC), FundBox, BlueVine, and LoanBuilder.

On Deck makes money in two different ways:

1. Net Interest Margins: What they receive on loans vs. what they pay for their loans
2. Licensing fees on their On Deck as a Service (ODX)

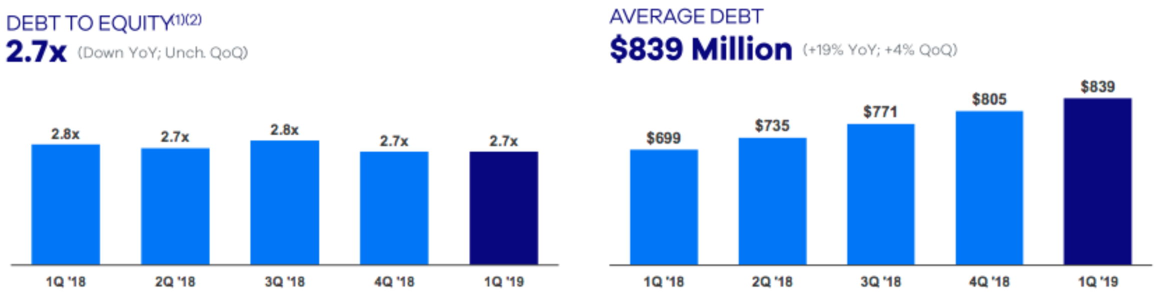
Let's discuss the financials and examine the health of business - particularly the core of ODNK; lending.

In their most recent Q1 report that just came out last week, ONDK posted:

- Q1 Non-GAAP EPS of $0.10 missing Wall Street estimates by $0.01 on revenue of $110.17M (+22.0% Y/Y) in-line with estimates.
- Lowered guidance
    - Sees full-year 2019 gross revenue guidance to $435M-$455M vs. prior view of $445M-$465M issued in February
    - Now sees high single-digit percentage growth in loans vs. low double-digit percentage growth in the February guidance; sees stable net interest margin compared with a slight increase previously expected.
    - Sees Q2 gross revenue of $108M-$112M (consensus estimate is $112.3M) and adjusted net income of $7M-$11M.
- Q1 adjusted net income of $8.3M, or 10 cents per share, fell from $15.9M, or 20 cents per share, in Q4 2018 and rose from $6.4M, or 8 cents per share, in the year-ago quarter.
- Q1 loans increased 3% Q/Q and 19% Y/Y with unit volume down 5% Q/Q and up 15% Y/Y.
- Q1 gross revenue of $110.2M, in-line with consensus estimate, was essentially unchanged from Q4 and up 22% Y/Y.
- Loan yield of 35.6% fell from 36.6% in the prior quarter, reflecting a decline in portfolio performance was pricing was generally stable.
- Return on equity increased from -2.9% in Q1 2018 to +7.7% in Q1 2019, but down from 19.2% in Q4

We dug into the numbers a bit deeper and it didn't get too much better:

- The 15+ Day Delinquency Ratio increased 120 basis points *sequentially* to 8.7%
- Net Interest Margin was 29.5%, down from 30.0% the prior quarter, up from 27.8% a year ago
- The company sees $30-40M in adjusted net income for 2019 – this would be down from $45.8M in 2018 despite guidance for revenues increasing from $398.4M in 2018 to the 2019 guidance of $435M-$455M indicating weaker margins/more loan delinquencies
- Cash balance stands at $60M, unchanged QoQ but down from $70M last year while debt remains fairly high at $839M
- Debt to equity levels remain high and virtually unchanged at 2.7x



***For those unaware of what some of these terms above mean please scroll all the way to the bottom of the document to view the glossary

So essentially what we're seeing here is that ONDK is expecting revenues in 2019 to now grow approx. $40M, or 9-11% and adjusted net income to fall at a midpoint of 20% Y/Y.

When looking at valuations we might go ahead and think that ONDK is fairly cheap fundamentally but this isn't necessarily true. While ONDK is trading at 10x P/E, this is still relatively expensive compared to the following who are projecting to grow their net income and EPS as opposed to ODNK who is expecting it to fall:

Bank of America – 10.5x

JP Morgan Chase - 11.5x

Citigroup – 8.9x

Goldman Sachs – 8.6x

Qudian Inc – 4.8x

If we examine the Price to Book valuations the same applies. ONDK currently trades at 1.22x book value (book value is $3.89 per share as per Q1 documents):

Bank of America – 1.2x

JP Morgan Chase – 1.6x

Citigroup – 0.9x

Goldman Sachs – 1.0x

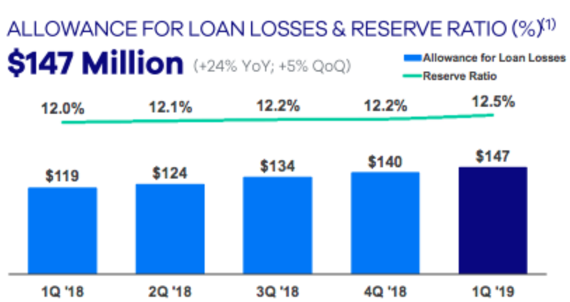
Qudian Inc – 1.5x

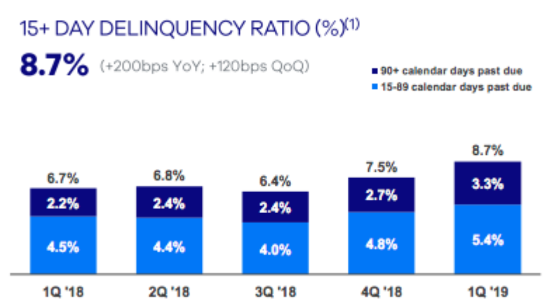
When we examine stocks that have been in a freefall like ONDK, we ask ourselves where could the bottom be? Obviously, the answer is always the same: Zero. But if bankruptcy isn't on the table, where would the realistic bottom be, especially for a company like ONDK?

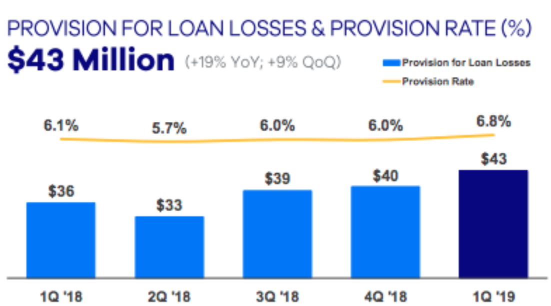
Knowing that established companies like that of Citigroup, and at one point or another the others, have slipped below their book value makes us quite certain that $3.89 could (not will) but could easily be breached.

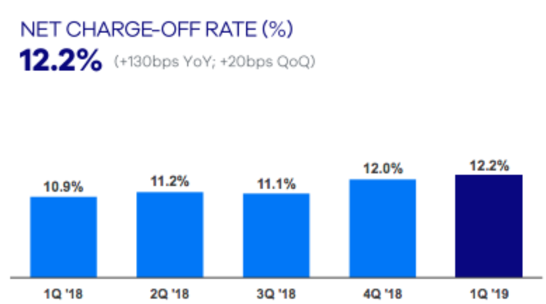
The company has a lot they still need to work out and there is a solid possibility the company issues more shares to get their cash up as $60M isn't too much in the vault with a debt pile like theirs and negative free cash flow.

Let us be clear, we think ONDK has done a great job transitioning the business in 2018. Management has finally steered the company into the green with regards to profitability, but we feel the work is still not done and we view 2019 as another year for the company to work its issues out. For example, as of December 31, 2018, their customers had a median annual revenue of approximately $681,005, with 90% of customers having between $148,699 and $4.2 million in annual revenue and have been in business for a median of 9 years, with 90% in business between 2 and 28 years. During 2018, the average size of a term loan they made was $55,490 and the average size of a line of credit extended to their customers was $33,689. These are great numbers off the bat, but as they've been growing their loans they've appeared to have lowered the quality a bit. Refer to the charts below and we'll see some sharp and concerning rises in what ONDK is setting aside and expecting for loan losses. In addition, their net charge off (write off for bad debts basically), has jumped from 10.9% to 12.2% Y/Y. This is something definitely worth noting alongside the 15-day delinquency ratio we already touched upon which has climbed from 6.7% to 8.7%.

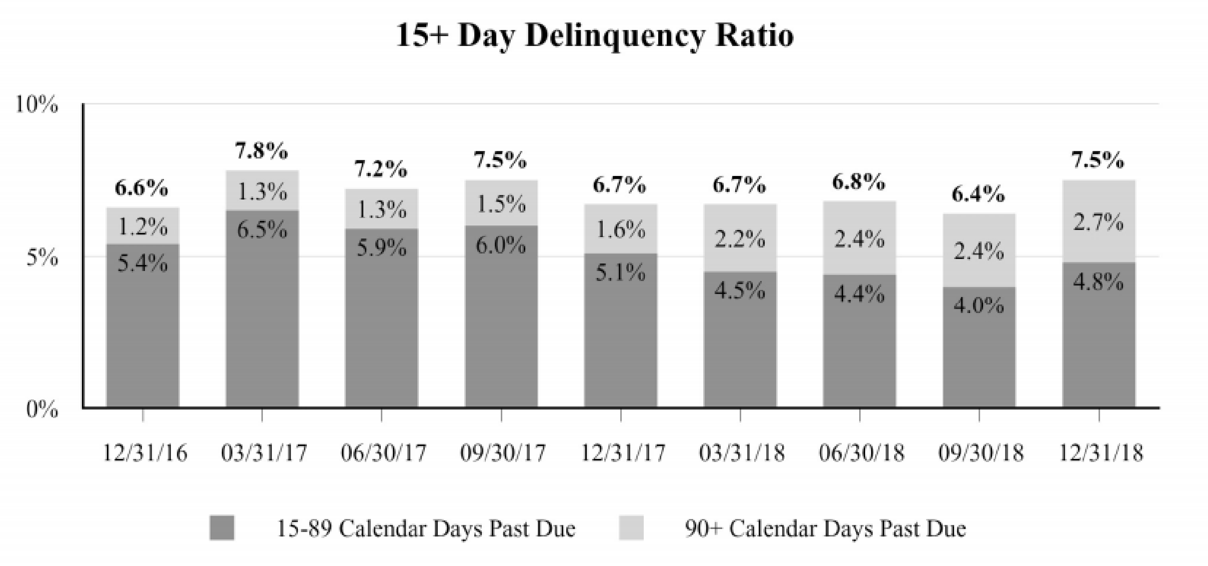








Below are the trends, excluding Q1, in ONDK 15 Day Delinquency Ratio dating back to Q4 2016 that we found in the company's 2018 10K.



Never before has ONDK's 15-day DR, crossed above 7.8%, until Q1 of this year when it skyrocketed to 8.7%, 3.3% of which is 90 days overdue vs. the previous high of 2.7% in Q4 2018 – an even worse sign of not getting that money back.

For reference, you can also view the list below to see how ONDK is doing Y/Y.

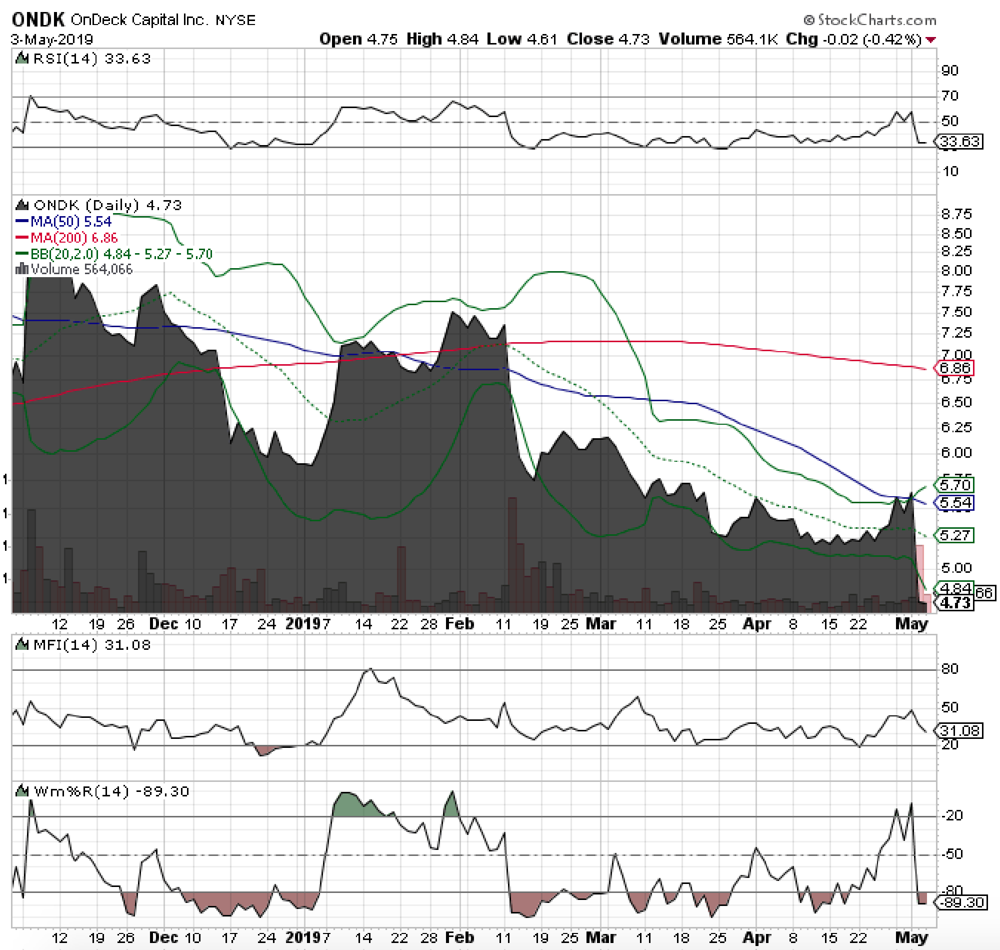
	As of or for the Year Ended December 31,		
	2018	2017	2016
		(dollars in thousands)	
Originations	$ 2,483,596	$ 2,114,663	$ 2,403,796
Loan Yield	36.2%	33.8 %	33.2 %
Cost of Funds Rate	6.3%	6.2 %	5.9 %
Net Interest Margin	29.0%	26.1 %	25.4 %
Provision Rate	6.0%	7.5 %	7.4 %
Reserve Ratio	12.2%	11.6 %	11.2 %
15+ Day Delinquency Ratio	7.5%	6.7 %	6.6 %
Net Charge-off Rate	11.3%	15.8 %	12.0 %
Efficiency Ratio	44.6%	47.3 %	66.6 %
Adjusted Efficiency Ratio*	40.1%	42.9 %	61.1 %
Return on Assets	2.6%	(1.1)%	(9.2)%
Adjusted Return On Assets*	4.3%	0.4 %	(7.4)%
Return on Equity	10.0%	(4.5)%	(27.7)%
Adjusted Return On Equity*	16.5%	1.6 %	(22.4)%

*Non-GAAP measure. Refer to "Non-GAAP Financial Measures" below for an explanation and reconciliation to GAAP.

Moving on, what we are actually most excited about with On Deck, is ODX – their licensed software as a service. Currently, only $15M of the company's nearly $400M in annual revenue comes from ODX – their main two users are PNC and JPM. We will add that it is odd that they would license out their technology to the larger banks considering it's their technology and ability to help smaller businesses out that allows them to have a competitive advantage vs. the bulge bracket banks out there.

ODX doesn't just interest us from the way it's being used but also from the perspective that it is a high margin business and could be something down the road, if revs grow large enough, will allow On Deck to achieve and garner a much higher multiple on their valuation. As we've already discussed, ODNK is being priced like a traditional bank. If ODX can really get some legs under it then essentially they'll be transitioning more into a fintech SaaS company with higher margins, less risk, and overall more love from the Street. Like we already mentioned, ODX only makes up 3.75% of revenues so it still needs time to grow but it's something that we will most certainly be watching heading into 2020.

Technically speaking, the stock has blown through of all its supports – Bollinger bands, moving averages, fibonnaci levels, etc.



As crazy as it seems, the stock still isn't sold off on RSI or MFI, and has recently hit oversold on the Williams %R but that's not enough for us to enter the position as we've seen many, many times that it falls into that oversold area quite often and even has an act of staying there for weeks on end.

We are interested in On Deck but right now we don't like the timing and also don't see any near-term catalysts on the horizon. We still think they are working out some problems and 2019 will be another year of rebuilding. We think they've done a great job turning things around in 2018 but have to see their execution play out in 2019 as it's off to a rough start with those Q1 numbers they posted and forecasted.

We will be keeping an eye out for new clients for ODX. That's where we think they can be a real differentiator in the space. Until then, we would not be surprised, even after all this falling, if shares want to test their book value of $3.89. Before then $4.20-4.25 might put up a good fight because it was a bottom the stock made back in January of 2018.

It's also worth mentioning that if ONDK does continue to fall, it becomes a greater bargain for other financial services companies to either purchase or perhaps we see some consolidation amongst the peers we mentioned in the beginning of the report.

Glossary

Originations

Originations represent the total principal amount of the term loans we made during the period, plus the total amount drawn on lines of credit during the period. Many of the repeat term loan customers renew their term loans before their existing term loan is fully repaid. In accordance with industry practice, originations of such repeat term loans are presented as the full renewal loan principal, rather than the net funded amount, which would be the renewal term loan's principal net of the unpaid principal balance on the existing term loan. Loans referred to, and funded by, our issuing bank partners and later purchased by us are included as part of our originations.

Loan Yield

Loan Yield is the rate of return we achieve on loans outstanding during a period. It is calculated as annualized Interest income on Loans including amortization of net deferred origination costs divided by average Loans. Annualization is based on 365 days per year and is calendar day-adjusted. Loans represents the sum of loans held for investment and loans held for sale at the end of the period. Loan Yield replaces our previous metric, Effective Interest Yield. Loan Yield is calculated using interest income on Loans, while Effective Interest Yield was calculated using Interest income.

Cost of Funds Rate

Cost of Funds Rate is calculated as Interest expense divided by average debt outstanding for the period. For periods of less than one year, the metric is annualized based on four quarters per year and is not business day or calendar day-adjusted.

Net Interest Margin

Net Interest Margin is calculated as annualized net interest income divided by average Interest Earning Assets. Net Interest income represents Interest income less Interest expense during the period. Annualization is based on 365 days per year and is calendar day-adjusted.

Provision Rate

Provision Rate equals the provision for loan losses for the period divided by originations of loans held for investment for the period. Because we reserve for probable credit losses inherent in the portfolio upon origination, this rate is significantly impacted by the expectation of credit losses for the period's originations volume. This rate may also be impacted by changes in loss expectations for loans originated prior to the commencement of the period. All other things equal, an increased volume of loan rollovers and line of credit repayments and re-borrowings in a period will reduce the Provision Rate. The Provision Rate is not directly comparable to the net cumulative lifetime charge-off ratio because (i) the Provision Rate reflects estimated losses at the time of origination while the net cumulative lifetime charge-off ratio reflects actual charge-offs, (ii) the Provision Rate includes provisions for losses on both term loans and lines of credit while the net cumulative lifetime chargeoff ratio reflects only charge-offs related to term loans and (iii) the Provision Rate for a period reflects the provision for losses related to all loans held for investment while the net cumulative lifetime charge-off ratio reflects lifetime charge-offs of term loans related to a particular cohort of term loans.

15+ Day Delinquency Ratio

15+ Day Delinquency Ratio equals the aggregate Unpaid Principal Balance for our loans that are 15 or more calendar days past due as of the end of the period as a percentage of the Unpaid Principal Balance at the end of the period.

Net Charge-off Rate

Net Charge-off Rate is calculated as our annualized net charge-offs for the period divided by the average Unpaid Principal Balance outstanding during the period. Net charge-offs are charged-off loans in the period, net of recoveries of prior charged-off loans in the period. For periods of less than one year, the metric is annualized based on four quarters per year and is not business day or calendar day-adjusted.

Efficiency Ratio

Efficiency Ratio is a measure of operating efficiency and is calculated as total operating expense for the period divided by gross revenue for the period.

Adjusted Efficiency Ratio

Adjusted Efficiency Ratio is non-GAAP measure calculated as total operating expense divided by gross revenue for the period, adjusted to exclude (a) stock-based compensation expense and (b) items management deems to be non-representative of 44 operating results or trends, all as shown in the non-GAAP reconciliation presentation of this metric.