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GreenSky, Inc. (GSKY)

Q3 2018 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you and welcome to the GreenSky Third Quarter Fiscal 2018 Earnings Conference Call. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session and instructions will be given at that time. We're webcasting this call live on the GreenSky Investor Relations website. After the completion of the call, a recording of the call will be made available on the same site.

I would now like to turn the conference over to Rebecca Gardy, Senior Vice President of Investor Relations at GreenSky. Please go ahead.

Rebecca Gardy
Senior Vice President, Investor Relations, GreenSky, Inc.

Thank you, Victor, and good morning, everyone. This morning, GreenSky issued a press release announcing results for its third quarter ended September 30, 2018. You can access this press release on the Investor Relations section of the GreenSky website.

Presenting on today's call will be David Zalik, GreenSky's Chief Executive Officer; Gerry Benjamin, our Chief Administrative Officer and Vice Chairman; and Rob Partlow; our Chief Financial Officer.

We will be making forward-looking statements on our call today, statements that are based on current assumptions and are subject to risks and uncertainties that could cause actual results to differ materially from those projected. We disclaim any obligation to update any forward-looking statements except as required by law. Information about these risks and uncertainties is included in our press release this morning as well as in our filings with regulators.

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Also, our commentary today will include certain adjusted financial measures, which are non-GAAP measures. Non-GAAP measures are not intended to be considered in isolation from a substitute for or superior to our GAAP results, and we encourage you to consider all measures when analyzing GreenSky's performance. We have provided reconciliations of the non-GAAP financial measures to GAAP financial measures in today's earnings press release available on our website. Following our prepared remarks, we will take your questions.

As a courtesy to other participants, please ask no more than two questions. In the event you have additional questions that are not covered by others, please feel free to re-queue and we will do our best to come back to you. Thank you for your cooperation on this.

And with that, I'll turn it over to David.

David Zalik

Founder, Chairman & Chief Executive Officer, GreenSky, Inc.

Thanks, Rebecca. Good morning, everyone, and thank you for joining us today. I'm pleased to share the results of our third quarter performance, which continued to illustrate GreenSky's unique combination of growth and profitability. I'll also touch on exciting developments as we focus on the vast market opportunities for our technology-enabled promotional point-of-sale financing products.

We generated record adjusted EBITDA of $58.9 million, a growth of 27% from the third quarter of 2017. Year-to-date through the third quarter, adjusted EBITDA was $138.5 million, an increase of 25% over last year. As a percentage of revenue, adjusted EBITDA was 52% in both the third quarter of 2018 and 2017.

We delivered pro forma earnings this quarter of $39 million, up 23%. On a fully diluted basis, pro forma earnings were $0.21 per share. We had another strong quarter in terms of originations. Total transaction volume increased to $1.4 billion this quarter. Each month this quarter, we facilitated home improvement originations of approximately $400 million on the GreenSky platform, and we expect that run rate will continue to accelerate in 2019 and beyond.

We expect our home improvement originations to grow by approximately $900 million to $1 billion in each of fiscal 2018 and 2019, against a total addressable market in home improvement of over $300 billion. We have a long runway ahead to get to a meaningful market share.

We remain equally as convicted in our rapidly growing elective healthcare business, as elective healthcare providers strive to improve patient access, GreenSky helps them by facilitating financing that provides patients affordable access to quality care. Our growth trajectory in elective healthcare transaction volume continued to mirror what we saw early on in our home improvement business and it is on track to exceed 10% of monthly enterprise-wide volume by the end of next quarter. Moreover, we expect to more than double our elective healthcare business in calendar year 2019.

This brings me to the topic of liquidity and funding. From a funding perspective, let me provide an update as to the status of our bank partner consortium. Existing bank partners increased their GreenSky program funding commitments by $1.6 billion in the third quarter.

In addition, Chicago-based BMO Harris Bank, a wholly-owned subsidiary of Bank of Montreal, the eighth largest bank in North America, and Troy, Michigan-based Flagstar Bank, have joined the GreenSky ecosystem since our

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last earnings call. Including their commitments of $2 billion in aggregate, our bank partner funding is now $11.5 billion, an increase of $3.5 billion since the second quarter.

Bank demand for loans originated by the GreenSky platform remain very strong as the quality of our bank partners' portfolio remains outstanding. The average FICO score for loans originated in the third quarter was 768. In addition, our loan servicing portfolio remains high quality with an average FICO of 757. Furthermore, borrowers with FICO score over 700 were more than 85% of the portfolio.

We ended the quarter with $294 million in unrestricted cash on our balance sheet and year-to-date we have generated approximately $167 million in free cash flow. This morning we announced our intent to repurchase up to $150 million shares of our Class A common stock as an important component of our overall capital allocation strategy.

We have the utmost confidence in the long-term fundamentals of our business and we believe the intrinsic value of our stock far exceeds what is reflected in the current GreenSky market price per share. Our management team and the board of directors want to opportunistically take advantage of the decline as we aim to maximize the benefit for our long-term shareholders.

I'm excited to share an update on our multifaceted collaboration with American Express. Over the eight weeks since American Express began cross marketing the GreenSky platform to American Express accepting home improvement merchants, we have received over 1,000 merchant referrals.

We are also excited to announce that the launch of the Amex direct-to-consumer pilot is on track for the first quarter of fiscal 2019 and will occur in five of the country's largest metropolitan areas; Atlanta, Chicago, Dallas, Los Angeles and Tampa.

American Express will be marketing a highly attractive promotional home improvement installment loan powered by GreenSky to select preapproved American Express card members with such loans to be funded by American Express Bank. As a reminder, we have not included any impact of our American Express alliance in our expectations for fiscal years 2018 or 2019.

This brings me to the topic of interest rates, pricing and the overall macro environment, as we look forward including recalibrating our full-year 2018 and 2019 guidance. As many of you know, the 2-year swap rate has risen dramatically by some 80% from 1.58% to 2.89% over the 12-month ended October 31, 2018, directly increasing our bank waterfall cost of funds.

Yet as I just reviewed, our growth and profitability for the quarter remained strong. We adjust to escalating bank interest rates through a combination of transaction fee increases, loan APR increases, and product design strategies, such as shortening the duration of the promotional period. These actions offset the impact of higher bank cost of funds and preserve the lifetime economics of loan originations.

As we discussed last quarter, while we enacted certain loan product price increases beginning in the first half of the year, there's a lag effect delaying our revenue as home improvement loan originations generally occur over a 180-day purchase window, and higher APR loans with lower transaction fees push revenue into the future.

We are encouraged as our transaction fee percentage this quarter was up 7 basis points over the second quarter, and we expect that we have passed the point of inflection as the decline in the transaction fee rate attributable to solar merchants has run its course and the impact of price changes are beginning to be visible. In addition to

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achieving higher transaction fee rates, we also saw higher average loan APR's such that third quarter originations reflects 175 – 177 basis points higher than third quarter of 2017.

Finally, as a reminder, we anticipate mild seasonal origination headwinds during the fourth quarter and continuing into January before we merge into our stronger, seasonal periods of the second and third quarter. As a result of the above factors, we're recalibrating our fiscal 2018 full-year guidance. We will also take this opportunity to provide fiscal 2019 guidance. Rob will go through the specifics in a few minutes.

We're pleased with this quarter's results. We certainly have no lack of growth opportunities within the vast addressable home improvement and elective healthcare markets. We're seeing early signs of success within our e-commerce and specialty retail businesses, representative new merchants added into our specialty retailing segment, include a premium at-home fitness equipment manufacturer, a 300 dealer billiards manufacturing company, one of the largest home security and alarm monitoring companies, and a 350 merchant gemstone purchasing co-op.

In aggregate, these third quarter wins represent approximately $200 million in potential annual transaction volume. We continue to be aggressively focused on initiatives where we can bring even higher value to our merchant network and ultimately their consumers. With all this potential ahead, hopefully you will understand why I'm excited about GreenSky's future.

I will now turn it over to Gerry, to comment on our additional key operational metrics. Gerry?

Gerry R. Benjamin

Vice Chairman & Chief Administrative Officer, GreenSky, Inc.

Thank you, David. For those of you that are new to the GreenSky's story, the company's recurring revenue business model is unusually attractive. And that the company's core value proposition resonates strongly with its growing network of merchants, funding bank partners, and GreenSky program consumer borrowers, resulting in sequentially growing recurring revenues, unrivaled low customer acquisition costs, and highly attractive operating margins.

We reported a 40% increase year-over-year and the number of merchants leveraging the GreenSky platform with 14,163 active merchants, including 11,779 home improvement merchants, and 2,384 elective healthcare providers. This growing network of merchants and providers sets up a virtuous cycle of referrals and is a key for GreenSky competitive advantage.

We also continue to see strong volume growth by our home improvement merchants as the dollar volume of transactions originated by merchants acquired in the first nine months of 2018 was over 50% greater than the same period in 2017 on a comparable basis.

As of September 30, 2018, our cumulative customer accounts or the aggregate number of consumer accounts approved on our platform since our inception was 2.1 million, an increase of 44% over the prior year. We have now facilitated over $15 billion of loan originations with this customer base since our inception. And as previously indicated, we are only just beginning to capture this potential market.

As David referenced in his comments, we anticipate doubling our elective healthcare transaction volume in 2019. Our product and technology teams have been hard at work over the past six months and we are excited to be soon delivering our first revolving consumer loan product in support of our growing elective healthcare business.

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We have three multi-market beta tests lined up with large national dental and veterinary medicine providers that in the aggregate, support more than 1,600 clinical sites; staffed by approximately 5,000 healthcare providers currently generate an aggregate annual patient finance volumes in excess of $350 million.

Our ability to offer a revolving GreenSky Patient Solutions Dental Card and a GreenSky Patient Solutions Vet Card designed for everyday recurring, category-specific expenditures will serve as a wonderful complement to our call – core installment loan product. And the availability of such a loan product has been pivotal in securing these large exciting beta tests.

Lastly, I'd like to review our third quarter Origination Productivity Index or OPI. As a reminder, this key performance measure captures the future net cash flows to be generated related to the subject quarters originations, expressed as a percentage of the quarter's dollar origination. Simply put, it measures the productivity of every dollar originated through the GreenSky platform.

Importantly, our Origination Productivity Index remained incredibly stable during the third quarter at 22%, illustrating that even with rising interest rates; we continue to maintain the overall productivity of every dollar of volume originated through the GreenSky technology platform.

We continue to have three levers at GreenSky's disposal to optimize OPI. These levers include; transaction fee rate, loan product APR, and the length of the loan product promotional periods offered. OPI computations are again contained in the financial presentation for the third quarter that has been posted on the GreenSky Investor Relations website.

And now, I'll turn it over to Rob for a brief review of our third quarter results and to layout the revisions to our expectations for our fiscal 2018 and full-year 2019. Rob?

Robert G. Partlow

Chief Financial Officer & Executive Vice President, GreenSky, Inc.

Thank you, Gerry. Before I begin, I would like to note that all my remarks will be as compared to the third quarter of 2017, unless otherwise noted. As David and Gerry highlighted, GreenSky continues to grow transaction activity with our existing merchants and bring new merchants on a daily basis, leading to strong financial performance this quarter.

Revenue grew by 29% to $113.9 million during the quarter. The impact of the higher transaction volume this quarter was offset by a decrease in the average transaction fee per dollar originated. Compared to the third quarter of last year, transaction fee rate decreased to 6.91% compared to [ph] 7.27% (15:27) in the third quarter of last year as a mix of high transaction fee solar business decreased from 12% to just 4% of originations this quarter.

However, on a sequential basis, the transaction fee rate of 6.91% was up 7 basis points over the second quarter as the price – as price increases begin to take hold, even while the mix of origination shifted [indiscernible] (15:51) with higher APRs.

As David noted, we have reached a point of inflection during the quarter for the trajectory of our transaction fee rate as the diminishing impact of solar was more than offset by price changes and mix shift within our products. Transaction revenue of $96.8 million, an increase of 27% and servicing and other revenue was $17.1 million, up 41%.

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GreenSky's average loan servicing portfolio for the three months ended September 30 was $6.6 billion, a 40% increase over the same period in 2017. At the end of the third quarter, the servicing portfolio was $6.9 billion compared to $4.9 billion last year. The total cost of revenue was $35.4 million or an annualized 2.2% of our average loan servicing portfolio, up from $22 million and 1.9% of our average loan servicing portfolio last year.

Origination related expense was $7.5 million, which represented 0.5% of transaction volume, an improvement from 0.6% in the third quarter of 2017. Servicing related expense was $9.1 million or 0.6% of the servicing portfolio on an annualized basis, consistent with the third quarter of 2017. The fair market value change of our financial charge reversal liability was approximately $18.8 million or an annualized 1.1% of our servicing portfolio, down from 1.3% last quarter, but up from 0.8% during the third quarter of 2017.

As a refresher, the FCR expense line item represents GreenSky's obligation to remit previously billed, but uncollected finance charges on deferred interest loans that are expected to pay off during the promotional period. The FCR expense is driven by a number of factors. First, the increase in the FCR liability period-over-period. This FCR liability has grown consistently with the growth of our servicing portfolio and represents 1.8% of the average servicing portfolio, consistent with each of the last six quarters.

Second, the remittance of our bank partners to – of our bank partners of finance charges that are reversed in the quarter due to the payoff of a deferred interest loan during its promotional period. This is referred to as settlements in our reporting and represented an annualized 2.9% of the average servicing portfolio during the third quarter of 2018. The settlement line will vary quarter-to-quarter, mirroring the seasonality of our loan origination activity.

And finally, the FCR expense line item is reduced by the receipt of incentive payments and collections on our charged-off loans [ph] AKA (18:37) recoveries, as well as the proceeds from the sale of rights to future recoveries, all collectively referred to as receipts in our reporting.

The FCR receipts represented an annualized 2.3% of the average servicing portfolio during the third quarter of 2018, consistent with the second quarter of 2018, but down from 2.6% during the third quarter of 2017. The year-over-year decline is largely due to the quarterly variances in charge-offs, recovery amounts, and the normal aging of the servicing portfolio as well as other small variations in the portfolios' composition.

So as you work through each component, you can see consistency in each factor, once you account for the normal seasonal fluctuations. For a more detailed FCR roll forward, that includes receipts and settlements, please refer to the slides we've published alongside of our earnings release this morning.

Operating expenses, which represents total cost of expenses excluding the aforementioned cost of revenue, were $24.3 million, down $1.9 million from $26.2 million during the third quarter of 2017, primarily as a result of a [ph] $2.6 million (19:47) of related party expenses in 2017 associated with finalizing our term loan facility.

In addition, we continue to benefit from our heavy investment in our technology resulting in a $1.2 million increase in capitalized expenses for internally-developed software. The largest component of operating expense is compensation and benefits expense that totaled $14.3 million for the third quarter 2018. 43% of the compensation and benefits expense related to our IT and product teams, reflecting our continued heavy investment in our technology platform.

Sales and marketing and personnel expenses make up the next largest portion of our personnel expenses at 32% of the total. And the remaining 25% relates to finance, HR and other corporate support functions. During the

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quarter, we adjusted our incentive program to align included a combination of both cash and incentives as well as long-term equity.

Our expense, net of $5.2 million, increased compared to 2017, primarily related to interest expense on our term loan B debt issuance, which closed in August of 2017. Our GAAP net income was $45.7 million or $0.20 per diluted share. Our adjusted EBITDA increased by 27% to $58.9 million from $46.4 million last year.

A reconciliation of adjusted EBITDA is provided in both the press release and the third quarter financial presentation, which are posted on the Investor Relations section of our website. Our pro forma net income was $38.8 million or $0.21 per diluted share.

This measure includes all of GreenSky's enterprise earnings for the period net of tax expense, which is calculated at our assumed effective tax rate of 21.8% on all of GreenSky's pre-tax income. Because of our Up-C structure, GAAP net income only reflects the tax expense on the earnings of our Class A shareholders.

As pro forma net income assumes that all earnings are subject to corporate taxation, we believe it is a useful measure for the comparability purposes, irrespective of the percentage of GreenSky owned by the C Corp.

Turning now to the key elements of our balance sheet. Our unrestricted cash was $294 million at the end of the quarter, an increase of approximately $70 million since year-end, reflecting our strong cash generation and a $59 million reduction in our loans receivable held for sale, which ended the quarter at $15 million.

Our finance charge reversal liability was $117 million, reflecting a $23 million increase since year-end, and consistent with the continued growth of our deferred interest loan originations.

That brings us to our outlook for the full fiscal year, and then we'll open it up for questions. Based on the company's performance at the end of third quarter, David's early remarks and the current market conditions, we now expect our fiscal 2018 for the transaction volume to increase between 30% and 35% to between $4.9 billion and $5.1 billion. Adjusted EBITDA to grow between 4% and 10% to between $165 million and $175 million.

The key variable impacting our updated guidance is our expectation that merchants will continue to select higher rate loan products as we change pricing to reflect the rising rate environment. Therefore, we expect our transaction fee percentage to increase only modestly from current levels during the fourth quarter.

In addition, we are refining our origination forecast to better account for seasonality and originations and consumer payment patterns. With the revisions to our full year 2018, and in conjunction with our fiscal 2019 planning, we are taking the opportunity to present our expectations for fiscal 2019 as follows; transaction volume to increase between 28% to 36% over fiscal 2018 to between $6.4 billion and $6.8 billion. The adjusted EBITDA to grow between 23% and 32% over fiscal 2018 to between $210 million and $225 million.

So with that, I would like to turn the call back over to David.

Rebecca Gardy

Senior Vice President, Investor Relations, GreenSky, Inc.

Okay. Thank you, Rob. This is Rebecca. As a reminder, please limit yourselves to two questions each so that we can get everyone in the queue. Thank you for your cooperation. And can we have our first question?

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QUESTION AND ANSWER SECTION

Operator: Yes, ma'am. Our first question is from the line of Jim Schneider from Goldman Sachs. You may begin.

James Schneider
Analyst, Goldman Sachs & Co. LLC

Q

Good morning. Thanks for taking my question. I was wondering if you can maybe address the housing slowdown in terms of re-sales and some of the results we're seeing from building materials companies that have reported in the market recently. Can you maybe talk a little bit about the housing slowdown? What's happening in the home improvement market generally speaking, and maybe quantify how that is impacting your 2019 guidance assumptions, and what factors you're assuming for 2019 with respect to that?

David Zalik
Founder, Chairman & Chief Executive Officer, GreenSky, Inc.

A

Jim, good morning. Thank you. We have not seen or detected any trace of impact from housing sales slowdown. The only thing that we see is a very large market that has labor shortages which makes everything take longer. So I think anybody doing home improvement in America today knows that a project that used to take three weeks seems to take five or six weeks, if you can get a contractor to your house. So Jim, we haven't seen any indication of impact from slowing home sales.

James Schneider
Analyst, Goldman Sachs & Co. LLC

Q

That's helpful. And then maybe as a follow-up, you reported that delinquency rate in your slides that's kind of back to where the [ph] $1.4 billion (25:45), I believe. Can you maybe talk about – that's kind of up a lot from where it was in Q2, but similar was Q3 last year. So can you maybe talk about how, if at all, that is impacting your assumptions in terms of the go-forward on FCR liability or other credit assumptions?

Gerry R. Benjamin
Vice Chairman & Chief Administrative Officer, GreenSky, Inc.

A

Hey, Jim. This is Gerry. One thing that we do want to point out, we got a net – number of questions last quarter when we chronicled 30-day default data that included our entire loan portfolio, including our deferred interest loans. This quarter we basically depicted the 30-day default data with respect to only those loans that have a payment due. If you're a borrower with a deferred interest loan and you don't have a payment, you obviously couldn't have defaulted. So the market was looking for more granular data, excluding those deferred interest borrowers without payments due.

So what you're seeing has what's been chronicled on the Investor Relations section of the site is just those loans with the payment due and you're seeing seasonal trends almost identical to last year, incredibly consistent. The quality of the credit performance is just where we would like it; we published the FICO bands again which you will see in the attachment. We are seeing no sign of deterioration other than the same kind of seasonal variances we would expect throughout the fourth quarters year-over-year.

James Schneider
Analyst, Goldman Sachs & Co. LLC

Q

Thank you.

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David Zalik
Founder, Chairman & Chief Executive Officer, GreenSky, Inc.
A

Certainly.

Operator: And our next question comes from the line of Reggie Smith from JPMorgan. You may begin.

Reginald Lawrence Smith
Analyst, JPMorgan Securities LLC
Q

Hey, good morning, guys. Thanks for taking my question. I'm not sure if I missed it or not, did you guys provide an updated revenue and EPS outlook for 2018? And if you did, well secondarily, where should this EBITDA reduction show up? Is it in revenues or is it more a FCR liability, where should we look to kind of refine it and reduce our model?

Gerry R. Benjamin
Vice Chairman & Chief Administrative Officer, GreenSky, Inc.
A

Hey, Reggie, I'll let Rob speak to that in detail. We went ahead and gave guidance with respect to originations and EBITDA purposely. We don't place a lot of credence on GAAP revenue for our own planning, our own internal management. That being said, we wanted to get those metrics out there quickly. What you will see, as David mentioned, is seasonal headwinds that will impact the origination level in fourth quarter as we would expect, and that's more a function of tightness of the labor market and the inability to get people on a job, that has anything to do with housing start. And then in our cost of sales, the increased cost of funds will run through the cost of services. Rob will speak to that. And of course, a little decrease in the take rate over last year would show up in a tapering of our transaction fee. But Rob, you want to supplement that?

Robert G. Partlow
Chief Financial Officer & Executive Vice President, GreenSky, Inc.
A

Yes, I mean, as Gerry highlighted, I think the key place you'll focus on is when we talked about the transaction fee rate versus – or the take rate versus what we had talked about previously. So I think when you think about it, it's really going to be primarily around the transaction fee volume revenue, is where you'll see the majority of the change.

David Zalik
Founder, Chairman & Chief Executive Officer, GreenSky, Inc.
A

Let me jump in. Hi, it's David Zalik, and make it clear that I along with the GreenSky senior management team are no way pleased with our revised calendar year 2018 projected results. In retrospect, we didn't do as proficient a job anticipating the steepness of the yield curve as I would have liked, although were hardly alone. And while the transaction fee take rate is down 70 basis points year-over-year driven by the reduction in solar, I know that we in essence pushed $35 million of profitability into future periods. And we're encouraged that the take rate is now not only showing stability but rising again.

This is not a management team that spent time reading its own press clippings, just to the contrary, we are going to double down our efforts to ensure that we're ahead of the curve, literally, with respect to rate increases, continue to grow our core home improvement business, another billion dollars in 2019, double our emerging elective healthcare business next year and enjoy nice wind in our sails as we're witnessing an APR in the portfolio that today is 177 basis points higher than this time last year.

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Reginald Lawrence Smith
Analyst, JPMorgan Securities LLC

Q

Understood. And if I could sneak one follow-up in. Just kind of mechanically I'm trying to understand – or I thought I understood how the required returns were kind of establishing the portfolio. My question is, when a loan is originated, obviously you know the APR, you know the transaction rate that you make, but the required return for the bank is also locked in at that point too, I thought. Is that correct or can that required rate on that...

David Zalik
Founder, Chairman & Chief Executive Officer, GreenSky, Inc.

A

No. That is correct. At the moment of origination, the consumers' interest rate is locked, the banks expected yield is locked, the impact of rising rates only impacts prospective origination. So at the beginning of every month or every quarter, any new origination for a new customer, the APR to the consumer is set and the banks expected margin is set. Reggie, did I answer your question?

Reginald Lawrence Smith
Analyst, JPMorgan Securities LLC

Q

Yes, so I guess the question is, with the steepening yield curve, essentially every month you guys can adjust your pricing. So, I guess what I'm asking is did you guys not adjust your pricing for the steepening of the yield curve that we've seen over the last eight or nine months, like I guess it seems from our perspective that it should have adjusted by itself or you should have done it before?

David Zalik
Founder, Chairman & Chief Executive Officer, GreenSky, Inc.

A

Sure. Right. So great question. So first of all, what we change is the pricing to the merchant. And that has a three to four to five month lag effect. So we see prices go up, we notify the merchants and let them know that prospectively next month the prices on new originations will go up. The new originations will come in over the subsequent four, five months and the bank margin expected will match that. But there is a delay in re-pricing to the merchants and what we are really seeing is that if our average take rate in our book has actually been outside of solar, incredibly stable for the last four years. In fact, it's been unbelievably stable.

Even as we've had nearly half a dozen rate increases, what the merchants do is if it's a particular merchant that used to spend 7% when Fed funds were near zero, and we've raised their price 200 or 300 basis points on whatever plan they were using, what the merchants do is say, I'm going to still only spend 7%. And they're going to choose a product that is more expensive for the consumer, which is still great for the consumer because relative to market rates, the consumer is still getting a promotion that is worth 7%. What that does is it pushes our revenue and margin into the next 24 months.

Reginald Lawrence Smith
Analyst, JPMorgan Securities LLC

Q

I see. Okay. Now that makes sense. I apologize for the detailed...

David Zalik
Founder, Chairman & Chief Executive Officer, GreenSky, Inc.

A

And I want to underscore, our lifetime profitability as summarized by the OPI metric is very stable. And so, the disappointment for us in 2018 is our average transaction fee take rate year-over-year is down 70 basis points, entirely driven by our solar mix going from a high of almost 20% of our business in 2017 to 4% of our business.

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And just to remind you, our solar business had an average take rate of 14% – nearly 14%. So we take nearly 20% of your business at a 14% and drop it to 4% and replace it with 7%, you can see what the impact is.

Now the lifetime profitability on every dollar is stable, but those dollars are pushed into the future. The other metric that we mentioned in the average APR of our origination is up 170 basis points. And that will generate incremental revenue and profit over the next two-and-a-half years of the weighted average life.

Reginald Lawrence Smith
Analyst, JPMorgan Securities LLC

Q

Understood. Thank you.

Operator: And our next question comes from the line of James Faucette from Morgan Stanley. You may begin.

James E. Faucette
Analyst, Morgan Stanley & Co. LLC

Q

Thank you very much. I had a question – maybe both for David. When you look at the new partners that increased the available funding et cetera, the introduction of those are bringing them online or in preparation for bringing them online at all impact the pacing of any of your business or changes in pricing et cetera? Just as you kind of were resetting the – kind of what the distribution of availability of funds is going to look like.

David Zalik
Founder, Chairman & Chief Executive Officer, GreenSky, Inc.

A

No. I want to reiterate that our demand, the appetite from our current ecosystem of bank partners far outpaces our most ambitious growth objectives. And in no way has that incredible appetite suppressed our growth. And so, it's only emboldened us. We're not surprised; we actually expected to increase our bank funding commitments by $2 billion. We are quite pleased that we've increased it just in the last 10 weeks by $3.6 billion. There is more demand than what we can fulfill. We were actually managing expectations from our bank partners down. We want a good, healthy ecosystem. It creates tremendous opportunity for GreenSky and for our more strategic bank partners. But that's only created opportunity for us and our strategic bank partners; it's not driven anything down.

James E. Faucette
Analyst, Morgan Stanley & Co. LLC

Q

Great. And then – thanks. And then, my second question relates to the share buyback, I think at least some investors will be pleased to see that the company wanted to buy back shares at these levels. But my question is the IPO proceeds all went to existing shareholders or pre-public shareholders as well as management and what are the limitations? Whether from a timing et cetera perspective that would keep those shareholders from also buying back shares, and when would those be resolved et cetera? Thank you.

Gerry R. Benjamin
Vice Chairman & Chief Administrative Officer, GreenSky, Inc.

A

The buyback that was announced was authorized by the GreenSky board, so it wouldn't be shareholders buying shares, it would be the corporate buying shares back. And to be clear, that's $150 million that was authorized. No time limit on that authorization, so we would expect to go in the market, and opportunistically buy those shares as long as we believe we're rewarding our long-term shareholders based on intrinsic value. So not contemplating shareholder level buys, but rather entity level buyback. I don't know if that answered your question fully, but I...

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James E. Faucette
Analyst, Morgan Stanley & Co. LLC

Q

It doesn't answer my question. I understand that. My question was that at the IPO, the proceeds of the IPO went to management and existing shareholders or shareholders before the company was public. And my question is, are those beneficiaries from the IPO at all restricted in their ability to buy back GreenSky shares? And if so, how long and under what circumstances could they enter the market to buy back shares?

Gerry R. Benjamin
Vice Chairman & Chief Administrative Officer, GreenSky, Inc.

A

As you're aware, all the insiders executed customary lock ups at the point in time of the IPO. I think those expire late November 20, 180 days after the effective date there. There is no limitation on insiders going and buying public in the market, buying shares, in a publicly – public market transaction, subject to blackout periods of course, which we institute judiciously

James E. Faucette
Analyst, Morgan Stanley & Co. LLC

Q

Great. Thank you very much.

Gerry R. Benjamin
Vice Chairman & Chief Administrative Officer, GreenSky, Inc.

A

Certainly.

Operator: Thank you. And our next question comes from the line of Andrew Jeffery from SunTrust. You may begin.

Andrew Jeffrey
Analyst, SunTrust Robinson Humphrey, Inc.

Q

Hi, guys. Good morning. I appreciate you talking the question.

David Zalik
Founder, Chairman & Chief Executive Officer, GreenSky, Inc.

A

Sure.

Andrew Jeffrey
Analyst, SunTrust Robinson Humphrey, Inc.

Q

So I just want to understand sort of from a big picture macro perspective, stepping back a little bit. I guess your research as I understand it is that merchants' willingness to pass on higher transaction costs to consumers, and consumers' willingness and desire to sort of absorb those costs is still that's a viable dynamic because the value prop to the consumer is still sufficient as an inducement. In other words, compared to other products in the market, even though the consumer might be paying more today than he was yesterday, he still feels like he's getting a pretty good deal. Did I sort of summarize that reasonably well....

Gerry R. Benjamin
Vice Chairman & Chief Administrative Officer, GreenSky, Inc.

A

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Yes. Absolutely. The consumer knows his cost of funds has gone up everywhere. If you're taking a deferred interest loan, you still can't do better than incurring not a penny of interest. And for a reduced rate loan, this is far more beneficial than putting it on an interest bearing credit card or other alternatives available. So the consumer is getting a great value, irrespective of the increased cost of funds.

David Zalik
Founder, Chairman & Chief Executive Officer, GreenSky, Inc.

A

Yes. There is a couple of things I think that we've learned here, and that absent a solar mix which drives down the average take rate, take rate is incredibly stable in a high rate environment and a low rate environment. And so, what we've seen is that in a higher rate environment, the merchants still want to spend roughly 700 basis points in most industries. In solar, they'll spend 14%, but everywhere else it's averaging 7%. And it's been averaging 7%. And as we raise prices to maintain margin, the merchants pick new plans, that to your point, have a lesser promotion for the consumer, but relative to the consumer market opportunity, it's still highly attractive for the consumer.

And that's another point that we validated is that if a merchant was offering their consumer 12-month no interest product in a near zero rate environment, that clearly increases that merchants sales average order value close rate. And in a higher interest rate environment, if the merchant still wants to spend 7%, the consumer may only get nine-month same as cash.

Well, something that's obviously very important and encouraging and validating is, to your point, that nine-month promotion in a high rate environment has the same positive impact. In other words, our model is very viable in a high rate environment or the low rate environment.

Andrew Jeffrey
Analyst, SunTrust Robinson Humphrey, Inc.

Q

Okay. I appreciate the color. And as I just think through sort of this dynamic, it sounds like a lot of what you're describing is fairly consistent with the business cycle, right. So to the extent that that's true, and the steepening of the yield curve and the increasing consumer funding costs is consistent with what we'd expect to see at this cycle, and we sort of follow the logical trail through and we think about, okay the next thing that happens is perhaps the value of the consumer's home falls or is perceived to have fallen, maybe unemployment starts to pick up, we get into a situation where it's less a question of consumer evaluating his funding option than the cost thereof, and more a question of is this a loan I want to take out. Then is there any reason to think we're not sort of – this is an early indication that the cycle is just kind of maturing and that these are the next steps, and if so how do you adjust for that, how do you think about that as we look forward the next year or two?

David Zalik
Founder, Chairman & Chief Executive Officer, GreenSky, Inc.

A

So we haven't seen a degradation in credit performance. We haven't seen a degradation in appetite from the consumer, and so that's very, very encouraging. I think we have a – full employment, we have a robust economy. We think we're seeing normalization. As we, in the future, see signs of economic or consumer stress, then there's opportunity to manage the business, support our bank partners both with credit policy and line policy changes as well as pricing changes. But we're not seeing any indication of an economic slowdown or a lack of demand by either merchants or consumers.

Andrew Jeffrey
Analyst, SunTrust Robinson Humphrey, Inc.

Q

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Okay.

Gerry R. Benjamin
Vice Chairman & Chief Administrative Officer, GreenSky, Inc.
A

Yeah. We've consistently gone on record saying that this strata of borrower, this 780 FICO, they have every intension of repaying their loans. The one macroeconomic effect that would impact performance is if saw people losing their jobs. And to David's point, or just not seeing any signs of all, in terms of weakness in employment, just to contrary we are probably closest to full employment we've seen in decades in this country.

David Zalik
Founder, Chairman & Chief Executive Officer, GreenSky, Inc.
A

Yes. I actually I want to reiterate an interesting point that Gerry alluded too. With an average 780 FICO score, our average customer actually does not need credit. This is about convenience, this is about commerce, this is about incremental. Our – a vast majority of our customers have plenty of open to buy, plenty of credit cards that are unused and often even have a home equity line and they find this to be much more convenient. And so I think when you're going into a cycle having a high income, high credit quality, profile of consumer that puts us and our bank partner network in a much more attractive position.

Andrew Jeffrey
Analyst, SunTrust Robinson Humphrey, Inc.
Q

I appreciate it. Thanks.

Operator: Thank you. And our next question comes from the line of John Davis from Raymond James. You may begin.

John Davis
Analyst, Raymond James & Associates, Inc.
Q

Hey. Good morning, guys. I wanted to start out and just make sure I understand the reduction in origination growth this year. So David, if I understand you correctly, it has entirely the labor shortage, and doesn't have anything to do with the steeper yield curve, kind of dampening demand for the product or merchants' willingness to offer promotional financing?

David Zalik
Founder, Chairman & Chief Executive Officer, GreenSky, Inc.
A

Certainly, no impact tempering demand. We are not seeing any signs from our merchants across the country. The one thing we are seeing is a consistent theme regarding tightening labor supply, and we make it a policy here at GreenSky, we never blame the weather for anything. But there's no question that the last two hurricanes have sucked up a lot of skilled labor in this country. And the last estimate we saw there's roughly $20 billion of insured property damage replacement work taking place right now, that's sucking up labor.

And accordingly it's tough for our merchant contractors to mobilize as quickly as they'd like. But we've seen this in the past with other natural tragedies. You'll see a deferral in terms of starts and at the end of those projects, there's a whole lot more discretionary spending that comes with it. So typically, despite we never want a natural disaster; it usually is a net positive to our business. But there is a little bit of deferral in terms of the start of jobs. That's all we are seeing. No weakness in core demand, no linkage to the housing market whatsoever.

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John Davis
Analyst, Raymond James & Associates, Inc.

Q

Okay. And then just trying to square here, the OPI is relatively stable, yet 2019 origination guidance is maybe down 3% from real expectations. Yet EBITDA guidance is now somewhere between 15% and 20% from original expectations. So just trying to square the profitability of the loans at the end of the day, not carrying up its take right or receipts with kind of the original or the initial 2019 EBITDA guidance for next year.

Robert G. Partlow
Chief Financial Officer & Executive Vice President, GreenSky, Inc.

A

Yes. A couple of things taking place here. Obviously, we are not going to make the same mistake twice. In our forward-looking plan, we have dialed in successive rate increases consistent with that guidance. If anything, we want these numbers to have a conservative bias, that's a given. And with respect to Andrew's prior question, if we had to do it all over again, there's a lesson learned that we haven't yet commented on. In prior periods, when we were pushing rate increases through in terms of pricing increases, the yield curve movement was very, very modest. And it wasn't unusual for us to put a rate increase through that would impact both transaction fee modestly and APR.

In our forecasting, we made the error of assuming that would occur in 2018 consistent with the prior five years. Given the steepness of the yield curve and the impact to the small business owners, in retrospect, they made a rather predictable decision, they're going to push as much on the consumer as they can first through higher APR, maintaining their out-of-pocket spend with their transaction rate and if they see the promotion not having the value, I believe then they would pay more in the way of transaction fee. But it hasn't been necessary.

So David's comment that we pushed $35 million of profitability into future periods is simple math. That's $5 billion of origination times 70 basis points. We know the OPI is stable, so the lifetime value of every dollar we are originating remains unchanged. It's strictly the point in time it gets recognized for GAAP purposes. So we do have some wind in our sails going into 2019 as well. But yes, there is a conservative bias here, no question about it.

David Zalik
Founder, Chairman & Chief Executive Officer, GreenSky, Inc.

A

And remember, transaction fees are kind of a current year period, and the excess cash flows coming over the life of the loan which can be two to three years. So there's a bit of a timing piece.

Operator: Thank you. And our next question comes from the line of Jason Kupferberg from Bank of America Merrill Lynch. You may begin.

Amit Singh
Analyst, Bank of America Merrill Lynch

Q

Hi, guys. This is actually Amit Singh from Bank of America Merrill Lynch. So just quickly trying to understand the steepening of the yield curve and how does it impact the transaction volume. So it seems like as the yield curve is steepening, it's definitely – it shows in your guidance for the full year, it is bringing the transaction volume down. So what are you assuming for – or what type of – how comfortable you are in your 2019 transaction volume guidance given that the interest-rate environment remains very volatile?

David Zalik
Founder, Chairman & Chief Executive Officer, GreenSky, Inc.

A

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Amit, thank you for the question. Let me clarify a really important point. The yield curve is not driving down volume. We're seeing no correlation. We are with the $5 billion business within a $100 million of our targeted annual volume. So we're not seeing a volume degradation, number one. What we're seeing is that revenue and profit, because of the mix and the higher interest rates, is being pushed into future period.

So our confidence level in the 2019 guidance is based on, one, we're predicting what we consider a modest $900 million to $1 billion of home improvement origination growth, an elective healthcare trajectory that we think is extremely viable, and a stable take rate whereas 18 we had a 70 basis point headwind because we slowed down solar from nearly 20% of our business to 4%. There's no other piece of our business that would have that impact. So our confidence in 2019 is based on transaction volume, which has been very predictable. Take rate, which is now for the last four months has shown not only stability but rising up and our forecast is assuming it flat and our forecasts assume several further rate increases from the Fed.

Amit Singh
Analyst, Bank of America Merrill Lynch

Q

Okay. Perfect. And then it seems like the Amex alliance is proceeding smoothly. Is any benefit from that, adding new merchants or any other benefit in your fiscal 2018 or fiscal 2019 guidance?

David Zalik
Founder, Chairman & Chief Executive Officer, GreenSky, Inc.

A

No. We're not – we are not assuming our guidance and our forecast that that has any impact. We actually have several initiatives. We see all of them as upside.

Amit Singh
Analyst, Bank of America Merrill Lynch

Q

All right. Thank you.

Operator: Thank you. And I see no further questions in the queue. I'd like to turn it back to Rebecca for closing remarks.

Rebecca Gardy
Senior Vice President, Investor Relations, GreenSky, Inc.

Thank you. That concludes the Q&A portion of our call. And before I turn it over to David for closing remarks, I did want to announce that we'll be attending the JPMorgan Ultimate Services Investor Conference on November 12th in New York. David?

David Zalik
Founder, Chairman & Chief Executive Officer, GreenSky, Inc.

Thank you, Rebecca. Notwithstanding our recalibrated guidance, I continue to be incredibly confident regarding the future of GreenSky. Our core U.S. home improvement and elective healthcare addressable markets alone exceed $650 billion, add in e-commerce and specialty retail, and we have a total addressable market or TAM that exceeds $1 trillion. Our mobile technology is truly special. We offer an incredible value proposition for each of our merchants, our bank partners, and the GreenSky program borrowers alike.

As we continue to demonstrate, our business model has inherent scale, as we continuously add more merchants to our platform, we reach more consumers and we facilitate more transactions for our bank partners. We have

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strong recurring revenue with each annual cohort of merchants increasing their volume on our platform. Our cost of merchant acquisition is in the low single-digits and our annual dollar-based retention of merchant transaction volume remains above a 100%. And most importantly for our shareholders, we deliver a unique combination of highly attractive operating margins, significant free cash flow, and exceptional growth.

With that, thank you all very much for joining us on today's call. We look forward to seeing many of you in New York at next week's upcoming JPMorgan Investor Conference and speaking with you on our fourth quarter earnings call. Thank you very much.

Operator: Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program and you may all disconnect. Everyone, have a great day.

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