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Q1 2017 21Vianet Group Inc Earnings Call

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CONFERENCE CALL PARTICIPANTS

Yang Liu *Morgan Stanley, Research Division - Research Associate*

PRESENTATION

Operator

Good morning, and good evening, ladies and gentlemen. Thank you, and welcome to 21Vianet Group's First Quarter 2017 Earnings Conference Call. (Operator Instructions)

Before we begin, I will read the safe harbor statement. This call may contain forward-looking statements made pursuant to the safe harbor provisions for the Private Securities Litigation Reform Act of 1995. These forward-looking statements are based on management's current expectations and observations that involve known and unknown risks, uncertainties and other factors not under the company's control, which may cause actual results, performance or achievements of the company to be materially different from the results, performance or expectations implied by these forward-looking statements. All forward-looking statements are expressly qualified in their entirety by the cautionary statements, risk factors and details of the company's filings with the SEC. 21Vianet undertakes no duty to revise or update any forward-looking statements for the selected events or circumstances after the date of this conference call.

With us today are Mr. Steve Zhang, the company's CEO; and Mr. Terry Wang, the company's CFO.

At this time, I would now like to turn this conference call over to Mr. Steve Zhang. Please proceed.

Zhenqing Zhang ***21Vianet Group, Inc. - CEO and Director***

Thank you, operator. Good morning and good evening, everyone. Thank you for joining us for the earnings call today. We have started 2017 with solid execution upon our restructuring plans, which are starting to bear fruit through improved financial and operating results. In particular, our hosting and related service business saw solid growth as revenue grew close to 19% year-over-year. And while our managed network service business continue to face challenges because of increased competition and pricing pressure, we executed on our strategy to optimize this business through cost controls such as reducing excess headcount and contract renegotiations. And we saw a noticeable improvement in our profitability in terms of EBITDA.

For hosting and related services, including IDC cloud and the VPN services, we continue to witness strong growth momentum in the first quarter. For the core IDC business, we added 14 cabinets; and we ended the quarter with 26,394 cabinets under our management, while improving the utilization rate to 75.8%. We increased the number of self-built cabinets by 224, while reducing the number of partnered cabinets by 210, resulting in higher gross margins. Meanwhile, our hosting churn rate was lower to 0.48% from 0.55% in the fourth quarter last year.

This past quarter we were also able to expand capacity contracts with some of our existing larger customers such as Didi, Momo and Xiaomi. Furthermore, we were able to sign contracts with new customers such as Shenzhen Ping An Bank, Vipshop, Xueersi [TAL Education] and Cool Pad.

In terms of our partnership with Warburg Pincus, I would like to reiterate that it is a long-term partnership, and everything is progressing on track so far. We are still planning to build a digital real estate platform, which aims to add 80,000 to 100,000 cabinets within the next 5 to 7 years. This past quarter we have already transferred 1 of our -- 1 of the 4 high-quality data centers into the initial joint venture as part of the closing process and are working on completing the remaining 3 asset injections. Furthermore, we are jointly exploring new data center project opportunities that we look forward to seeing more encouraging results in the near future.

Moving on to the cloud. We aim to provide more hybrid IT services that encompass all customer needs by leveraging all partnership with public cloud providers and our strong expertise and technology advantages in cloud and data centers. The result is a complete package of interconnection and hybrid cloud services, which combines the scalability and the cost efficiency of the public cloud with the reliability and the security of private cloud solutions.

In addition, we are glad to announce that we have partnered with Microsoft and Tencent to launch Microsoft Office Online, which offers Tencent Cloud users enhanced convenience of a mobile office anytime, anywhere as well as Microsoft Office collaboration among multiple enterprise users. 21Vianet will provide enhanced operational and maintenance solutions to enable cross-platform technical support and streamline use of Microsoft Office Online for Tencent Weiyun users. Leveraging Tencent Cloud's large user base, we believe that as the usage volume for Microsoft Office Online increases we'll provide additional technical service resources to support this initiative, which will drive more incremental cloud revenue down the road.

I would also like to mention that in late March of this year 21Vianet was approved as a silver level partner for Akamai's NetAlliance Program. As a NetAlliance partner, we'll be able to leverage the exceptional brand of Akamai, a global leader in CDN services, and to profitably grow our own CDN business. Specifically, this is completed through the D2G, or domestic to global, program, which allows domestic Chinese customers that wish to expand globally to leverage Akamai's CDN service to increase data transmission speeds for applications and websites.

Overall, we are pleased to see a robust improvement this quarter. Going forward, we'll further strengthen our restructuring efforts by focusing on expanding our core retail co-location business and cloud-neutral platforms, optimizing our managed network service business, shifting towards an asset-light business model and capitalizing on new growth opportunities in markets such as wholesale data center services and hybrid IT solutions. We remain confident in our ability to fortify our leading position as an Internet infrastructure service provider and to generate incremental value for shareholders.

With that, I would like to turn the call over to Terry, our CFO, to go through our financial results.

Shilian Wang *21Vianet Group, Inc. - CFO*

Thanks, Steve. First of all, we like to (inaudible) to report that our top line revenues of CNY 862 million outperforms the midpoint of our guidance for the first quarter of 2017. Secondly, I would like to talk about the profitability side of our business. In the first quarter, we witnessed positive signs from our efforts to control costs and improve our operational leverage. As a result, our adjusted EBITDA was CNY 100 million, exceeding the high end of our guidance of CNY 85 million by 18%, and our net loss narrowed by 23% year-over-year from CNY 151 million to CNY 117 million. As we move forward with our businesses restructuring, we remain committed to further driving the top line growth, improving our operating leverage and enhancing our profitability.

Now let's take a closer look at our first quarter of 2017 financial results. Before I begin, I'd like to state that we will present non-GAAP measures today. Our non-GAAP results exclude certain noncash expenses which are not a part of our core operations. The detail of these expenses may be found in reconciliation table included in our press release. Also note that all the financial numbers we are presenting today are in RMB, and the percentage change is year-over-year, unless otherwise stated.

Our net revenues were CNY 862 million compared with CNY 862 million in the prior period and CNY 901 million in the fourth quarter of 2016. Net revenues remained flat year-over-year due to the increase in revenues from hosting and related services being offset by the decrease in revenues from managed network services.

Net revenues from hosting and related services were CNY 707 million compared with CNY 597 million in the prior period and CNY 703 million in the fourth quarter of 2016. The increase year-over-year was primarily due to increase in the total number of billable cabinets as a result of an increase for demand from fast growth customers and the increase in utilization rate.

Our monthly recurring revenue per cabinet for the first quarter was RMB 8,363 compared with RMB 8,490 in the fourth quarter of 2016. The decrease in the monthly recurring revenue per cabinets was mainly attributable to lower bandwidth pricing.

Net revenues from managed network services were CNY 156 million compared with CNY 266 million in the prior year period and CNY 197 million in the fourth quarter of 2016. The decrease year-over-year was primarily due to continued increase of competition and pricing pressure.

Adjusted gross profit increased by -- was CNY 212 million compared with CNY 211 million in the prior year period. Adjusted gross margin was 24.5% compared with 24.5% in the prior year period.

Adjusted operating expenses were CNY 251 million compared with CNY 220 million in the prior year period. As a percentage of net revenues, adjusted operating expenses were 29.1% compared with 25.5% in the prior year period.

Sales and marketing expenses were CNY 66 million compared with CNY 77 million in the prior year period. The decrease was primarily driven by reduced agency fees.

General and administrative expenses were CNY 136 million compared with CNY 134 million in the prior year period.

Research and development expenses were CNY 38 million in the first quarter of 2017 as compared with CNY 42 million in the comparative period in 2016. The decrease was primarily due to the execution of our business restructuring.

Our adjusted EBITDA was CNY 100 million compared with CNY 109 million in the prior year period and CNY 52 million in the fourth quarter of 2016. Adjusted EBITDA margin was 11.6% compared with 12.6% in the prior year period and 5.8% in the fourth quarter of 2016.

Adjusted EBITDA for hosting and related services was CNY 153 million compared with CNY 94 million in the prior year period and CNY 130 million in the fourth quarter of 2016.

Adjusted EBITDA for managed network services was negative CNY 52 million compared with positive CNY 15 million in the prior year period and a negative CNY 78 million in the fourth quarter of 2016.

Adjusted net loss was CNY 84 million compared with CNY 74 million in the prior year period.

Adjusted net margin in the first quarter of 2017 was negative 9.7% compared with negative 8.6% in the prior year period.

Adjusted diluted loss per share for the first quarter of 2017 was RMB 0.12, which represents an equivalent of RMB 0.72 per ADS.

As of March 31, 2017, our cash and cash equivalents and short-term investment were CNY 1.26 billion, equivalent to USD 184 million.

Now let me provide you with our guidance for the second quarter of 2017. We expect our net revenue to be in the range of CNY 870 million to CNY 910 million compared with CNY 911 million in the prior year period. Adjusted EBITDA is expected to be in the range of CNY 100 million to CNY 120 million compared with CNY 16 million in the prior year period.

This concludes our prepared remarks for today. Operator, we're now ready to take questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Yang Liu from Morgan Stanley.

Yang Liu ***Morgan Stanley, Research Division - Research Associate***

I have 4 questions. The first one is that we find that excluding the bad debt provision Vianet cut the MNS-related costs year-on-year by CNY 15 million. Of course, excluding the bad debt, you cut it even more than that. Management just mentioned that it is from reducing headcount and contract renegotiation, but my question is can company continue to further reduce the cost going forward? The second question is that the first quarter has CNY 15 million bad debt. Is this also related with managed network service? I just want to confirm. What is the outlook for the bad debt issue going forward? The third question is could you please share more about the new cabinet pipeline in second quarter and also second half? The last question is can you share more about the recent Microsoft-Tencent-21Vianet partnership? Is it possible to further cooperate with a more domestic account vendor in future? And how can it help to boost 21Vianet's account revenue from Microsoft China?

Zhenqing Zhang ***21Vianet Group, Inc. - CEO and Director***

Thanks for the question. This is Steve. I'll first take a crack on your first question. Can we further reduce the cost in our managed network service going forward? Yes, we are still in the process of negotiating with a lot of suppliers regarding the bandwidth price, and we are seeing some positive progress -- direction and positive progress. And we will continue to drive our costs down and also try to enhance some of the sales contracts for some of the new customers. That's your first question regarding further cost optimization for our managed network services. Terry, you want to take the second question about the bad debt issue?

Shilian Wang ***21Vianet Group, Inc. - CFO***

Sure. The -- your second question is about the bad debt if it's related to the management network services. And for this couple of quarters, yes, the answer is yes. The last quarter, actually, remember I mentioned that we actually provisioned about CNY 47 million in noncollectible -- or it's -- that related to management network services. This quarter we have much lower, but it's still some uncollectible things we provisioned for the bad debt of approximately less than CNY 15 million that was put there in this quarter.

Zhenqing Zhang ***21Vianet Group, Inc. - CEO and Director***

Your third question is regarding the Q2 new cabinet pipeline. In the second quarter, we'll increase our self-built data center by capacity roughly between 1,200 cabinets to 1,500 cabinets. And we are already in the process of delivering all those numbers in the second quarter. What's your last question?

Yang Liu ***Morgan Stanley, Research Division - Research Associate***

My last question is, how can the Tencent-Microsoft-Vianet partnership help to boost cloud revenue from Microsoft China and also whether it's possible to further cooperate and include more cloud vendors in future?

Zhenqing Zhang ***21Vianet Group, Inc. - CEO and Director***

As we said, when the Microsoft Office Online usage goes up through all those partnerships, it will require more resources from our side, and this will drive more revenue to 21Vianet. Yes, definitely, we want this for more partnership opportunities with all public cloud vendors in China. And we'll continue to work closely with all those strategic cloud vendors.

Yang Liu ***Morgan Stanley, Research Division - Research Associate***

Just one follow-up question on the bad debt issue. What's the outlook for this in the second quarter or -- going forward? Is there still any legacy bad debt possible to reclassify as uncollectible in future?

Shilian Wang ***21Vianet Group, Inc. - CFO***

Thanks for the question. This last -- since last year and we cleaned up some of the legacy -- the bad debt or the account receivable area and found that the agings pretty long, so we've restructured and talked to them to make sure they're collectible. So since then, we -- quarter-by-quarter, we have reviewed and set a provision mark. And we pretty much had done that this couple of quarters. Next quarter, my view, we might have a very small portion. It's not going to be more than CNY 10 million, a few million, in the range. That's where we're looking at right now.

Operator

(Operator Instructions) Our next question comes from the line of Yang Liu from Morgan Stanley.

Yang Liu ***Morgan Stanley, Research Division - Research Associate***

Sorry, I have one more question regarding to the mix between self-owned and partnered cabinets. I noticed that the margin improvement of the hosting business is partly due to the mix change in the cell phone and the partnered data centers. But could you please share with us what is the margin for self-owned and what is the margin for the partnered data center?

Zhenqing Zhang ***21Vianet Group, Inc. - CEO and Director***

For self-build data center, the gross margin is roughly in 30%, 35%. For partnered cabinets, it's mostly we are -- rent from other providers' data centers to meet our customers' demand and resell to our customers in locations where we don't have our own data centers. Typically, the partnered data center carries roughly 10% gross margin on the cabinets side. And of course, we also sell our network services, the [BTT] network, and the network tends to carry higher, roughly in the range of 20% to 25% gross margin range.

Operator

(Operator Instructions) There are no further questions at this time. Ladies and gentlemen, that does conclude our conference for today. Thank you for participating. You may all disconnect.

Shilian Wang ***21Vianet Group, Inc. - CFO***

Thank you.

Zhenqing Zhang ***21Vianet Group, Inc. - CEO and Director***

Thank you.