21Vianet Group, Inc.
2Q17 Earnings Conference Call Script

Operator:

Good morning and good evening, ladies and gentleman. Thank you and welcome to 21Vianet Group's second quarter 2017 earnings conference call.

At this time all participants are in listen-only mode. We will be hosting a question and answer session after management's prepared remarks. 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 selected events, or circumstances after the date of this conference call.

With us today are Mr. Steve Zhang, the Company's Chief Executive Officer and Mr. Terry Wang, the Company's Chief Financial Officer. At this time, I would now like to turn this conference call over to Mr. Steve Zhang. Please proceed.

Steve Zhang, CEO

Thank you, Operator. Good morning and good evening everyone. Thank you for joining us for the earnings call today.

Our business realignment continued to generate fruitful results in the second quarter of 2017. Our core hosting and related services business continued its solid growth momentum during the quarter, as revenues increased by 11% year over year. While our managed network services business continued to face competitive challenges and pricing pressure, we continue to optimize this business by actively implementing various measures to control our costs and reduce expenses. Going forward, we will explore and evaluate strategic alternatives for our MNS business.

Now let me update you on our core hosting and related services business, which includes IDC, cloud and VPN services.

For our IDC business, we continue to see strong demand in this market, driven primarily by increased computing power and storage needs from the rise of big data, mobile internet, and internet of things. For example, our enterprise clients are relying more and more on big data to support their business intelligence applications, which will create a lot of demand for computing and storage capacity, resulting in the need for more data centers.

To capture this growing demand, we will increase our data center capacity through a variety of channels, including building cabinets ourselves and entering into strategic joint ventures. In the second quarter, we added 967 cabinets, resulting in a total of 27,361 cabinets under management. Our self-built cabinets, which have higher gross margins, increased by 1,453. At the same time, our partnered cabinets, which have lower gross margins, decreased by 486 in the second quarter. In addition, our hosting churn rate decreased from 0.48% to 0.24% this past quarter.

We were also able to expand our customer base in the second quarter through a new cooperation with the Payment and Clearing Association of China. They operate an online payment clearing platform called 网联, which clears payments made by non-bank third party payment agencies such as Alipay and Wechat Pay. Through this cooperation, they have selected 21Vianet to host their servers in Beijing, Shanghai, and Shenzhen. Furthermore, because of the growing popularity and usage of some of our client applications such as 饿了么 and 滴滴出行, we have seen increased demand for cabinet space from our existing client base.

In terms of our partnership with Warburg Pincus, as previously mentioned, it is a long-term partnership and everything is progressing on track. During the second quarter, we almost completed transferring another one of the 4 high-quality data center assets into the initial joint venture. In the long term, we still plan on reaching 80,000 to 100,000 cabinets within the next 5 to 7 years to build out our digital real-estate platform. Going forward, we want to expand our product offerings to include customized wholesale data center solutions, as we expect this segment of the market to grow significantly and we want to be well-positioned to capitalize on this trend.

This past quarter, we continued our efforts in hybrid IT services to encompass all our customer needs. For example, by leveraging our partnerships with public cloud providers and our strong technology advantages in cloud and data centers, we were able to deepen our business relationship with Xiaomi. Furthermore, we strengthened our cooperation with both AliCloud and Tencent Cloud. We now have fiber connectivity between 21Vianet's data centers and those of Alibaba and Tencent. This direct link allows us to offer more internet security solutions to our clients, with features such as Anti-DDOS.

Moving on to the MNS business, in the past few years we've experienced increasing competition and pricing pressure. I would like to give some more color on the current industry environment.

For our Aipu business, it has become significantly more challenging to compete in the last-mile fixed broadband industry since China Mobile entered this market. China Mobile was issued a fixed-line broadband license from the MIIT in December 2013, and since then, they have been employing aggressive strategies to gain market share from incumbent players such as China Telecom and China Unicom. This has directly adversely affected our Aipu business, as our subscribers have moved to cheaper, more attractive plans offered by China Mobile. In the near-term, we do not see any changes to this trend.

For our CDN business, we have also faced increasing competition, specifically from cloud providers such as Ali Cloud and Tencent Cloud. They are taking aggressive measures to cut prices, resulting in lower profitability for all CDN providers. This is causing a massive shakeup in the CDN industry, with all third party providers being adversely affected.

Despite the unfavorable industry backdrop, we are moving forward with our restructuring plans as we implement strict cost control measures by reducing headcount, and renegotiating bandwidth contracts with telecom operators to further optimize the network business, and we will continue to explore strategic alternatives for this business.

Overall, we are pleased with the solid results we achieved in the second quarter, which once again demonstrates the effectiveness of our restructuring and business realignment. I want to emphasize that we will continue to invest in our core IDC business because of the strong demand from our existing and prospective clients. By focusing more on the core business, we have already seen robust business and financial growth in this segment through improvements in our operating numbers, financial margins, and cash flow. Going forward, we will continue our restructuring efforts, and explore different strategic options and alternatives for the challenging MNS business.

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

Terry Wang, CFO

Thank you Steve.

First off, let me give you some financial highlights. Total net revenues were RMB879 million, which met our guidance for the second quarter. Even though this was a decrease of 3.5% year-over-year, it represented an increase of about 2% quarter-over-quarter. More specifically, revenues for our core hosting and related services increased by 10.9% year-over-year and 5.2% quarter-over-quarter.

Even though we faced challenging market conditions in the MNS business, due to our business realignment efforts, we were able to control costs and reduce expenses, resulting in improved profitability in the second quarter. Our gross profit increased by 8.8% year-over-year to RMB188 million, and our gross margin expanded to 21.4% from 19.0% a year ago. Our adjusted EBITDA also increased to RMB108.6 million, a significant improvement year-over-year and an 8.3% improvement quarter-over-quarter.

Moreover, we intensified our cash collection efforts. As a result, our accounts receivables declined sequentially and year-over-year to RMB674 million as of June 30, 2017. We were also able to generate RMB69 million of net cash from operating activities during the second quarter.

Going forward, we remain committed to our business restructuring. We will continue to optimize our cost and expense structure, while striving to revive our total revenue growth.

I would also like to mention that we completed our 3-year bond offering for 200 million USD at an interest rate of 7%. Given the challenging market conditions that we faced, we are pleased with the final offering size and coupon, especially since we saw similar recent deals in the market pricing much higher or at much smaller offering sizes.

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

Our net revenues were 879 million, compared with 911 million in the prior year period and 862 million in the first quarter of 2017. Net revenues slightly declined year over year due to the decrease in revenues from managed network services, which was partially offset by the increase in revenues from hosting and related services.

Net revenues from hosting and related services increased by 10.9% year over year to 743 million, compared with 670 million in the prior year period, and 707 million in the first quarter of 2017. The year-over-year increase was mainly due to the increase in revenues from our IDC and VPN business.

Our monthly recurring revenue or MRR per cabinet for the second quarter was 8,311, compared with 8,363 in the first quarter of 2017. The decrease in monthly recurring revenue per cabinet was mainly attributable to lower bandwidth pricing.

This quarter, we also began disclosing MRR for our hosting business. Hosting MRR per cabinet for the second quarter was 7,697, compared to 7,746 in the prior year period and 7,598 in the first quarter. The main difference between hosting MRR and total MRR is that the latter includes revenues from CDN.

Net revenues from managed network services were 135 million, compared with 240 million in the prior year period and 155 million in the first quarter of 2017. The year-over-year decrease was mainly due to increasing competition and pricing pressure.

Our adjusted gross profit increased by 9.2% to 219 million, compared with 201 million in the prior year period. Adjusted gross margin increased to 25 % compared with 22% in the prior year period.

Adjusted operating expenses decreased by 17.7% to 258 million, compared with 313 million in the prior year period. As a percentage of net revenues, adjusted operating expenses decreased to 29.4%, compared with 34.4% in the prior year period.

Sales and marketing expenses decreased by 15.1% to 71 million, compared with 83 million in the prior year period. The decrease was mainly driven by a decrease in third party sales commissions.

General and administrative expenses decreased by 10.1% to 139 million, compared with 155 million in the prior year period. The decrease was mainly driven by a reduction in headcount.

Research and development expenses were 43 million in the second quarter of 2017, as compared with 33 million in the comparative period in 2016. The increase was mainly driven by an increase in research staff for our core data center business.

Our Adjusted EBITDA increased to 109 million compared with 15 million in the prior year period and 100 million in the first quarter of 2017. Adjusted EBITDA margin increased to 12.4% compared with 1.7% in the prior year period and 11.6% in the first quarter of 2017.

If we exclude bad debt provisions from our adjusted EBITDA, our adjusted EBITDA margin is 14.2%, compared with 6.6% in the prior year period and 13.4% in the first quarter of 2017.

Adjusted EBITDA for our hosting and related services was 171 million compared with 108 million in the prior year period and 153 million in the first quarter of 2017.

Adjusted EBITDA for our MNS business was negative 63 million compared with negative 93 million in the prior year period and negative 52 million in the first quarter of 2017.

Adjusted net loss narrowed by 28.1% to 84 million compared with 116 million in the prior year period. Adjusted net margin in the second quarter of 2017 improved to negative 9.5%, compared with negative 12.8% in the prior year period.

Adjusted diluted loss per share for the second quarter of 2017 was RMB 13 cents, which represents the equivalent of RMB 78 cents per ADS.

As of June 30, 2017, our cash and cash equivalents and short-term investment were 758 million, equivalent to USD 112 million.

Now, let me provide you with our guidance. For the third quarter of 2017, we expect net revenues to be in the range of 860 million to 900 million, compared with 968 million in the prior year period. Adjusted EBITDA is expected to be in the range of 108 million to 122 million, compared with 68 million in the prior year period.

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

Closing remarks:
Once again, thank you all for joining us today. Please don't hesitate to contact us if you have any further questions. We look forward to talking with you in the coming quarters.