21Vianet Group, Inc.
3Q17 Earnings Conference Call Script

Operator:

Good morning and good evening, ladies and gentleman. Thank you and welcome to 21Vianet Group's third 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, CEO of 21Vianet. Please proceed, sir.

Steve Zhang, CEO

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

Our core IDC business maintained its steady growth in the third quarter, driven by more demand for computing power and storage space because of the continuous rise of big data, artificial intelligence, Internet of Things and mobile Internet.

Our self-built cabinets, which have higher gross margins, increased by 302 to 21,273. At the same time, we cleaned up our existing partnered inventory, which have lower gross margins, and reduced partnered cabinets by 239. During the quarter, several of our large-scale clients further expanded their capacity at our IDC centers. For example, JD Finance increased its cabinets by around 200 to accommodate its rapid growth in the installment payment, or Baitiao (白条), business. Ele.me (饿了么) added around 60 cabinets and Momo added close to 100 cabinets. And Xiaomi remained a loyal customer with over 900 cabinets under management, adding over 100 cabinets this past quarter.

To give some more color on our customers, we segment the market into three tiers: startups, small- and medium-sized businesses, and large-scale businesses. While we have a diversified base of customers across all three segments, we are seeing some startups move to public cloud service providers because of their relatively simple data storage requirements and for increased cost savings. However, as startups grow in size, their demands begin to vary, and they are no longer satisfied with one-size-fits-all solutions. Small- and medium-sized businesses start to migrate off public cloud and consider hybrid cloud solutions. As this occurs, we approach them and start to cultivate clients among small- and medium-sized companies which have the potential to grow.

As their operations grow further, they start to demand customized solutions and move into IDC centers like ours for three reasons: 1) data security, 2) quality of service, 3) value for price. We are uniquely positioned to serve small-, medium- to large-scale businesses. We actually incorporate their customized requirements into the design of our data centers, so our solutions are tailor-made for each large client from the ground up, such as with our relationship with Jing Dong (京东) and Xiaomi. As a result, our customers are not only highly satisfied with the solutions we provide, but also remain loyal to us for years to come. As our customers grow, we grow with them.

We believe we have carved out a sustainable niche in the highly competitive IDC market, and we pride ourselves for having three competitive advantages: network quality, carrier neutrality, and service quality.

First, our network is of extremely high quality, both in terms of minimal packet loss during data transmission and low network latency. For example, if you look at third party rankings by Bonree (博睿), a market network survey company, 21Vianet's data centers are consistently ranked in the top 3 in their 2017 Beijing data center network quality lists.

Second, we have a unique edge being both carrier-neutral and cloud-neutral. Our carrier-neutral advantage provides interconnection between multiple telecom carriers, while our cloud-neutral advantage benefits customers who deploy their IT infrastructure at our data centers by allowing them to connect directly to various cloud service providers through our cloud exchange. This setting will benefit our customers in diverse and flexible connectivity, as well as cost-efficiency.

Lastly, we have built a strong reputation with our industry-highest-standard quality of services, which not only helps us maintain a high retention rate among our existing customers, but also helps us attract new customers.

Our partnership with BMW, the world's leading automobile manufacturer, further demonstrates our competitive advantages. In the third quarter, we signed a five-and-half-year contract with BMW. Under the agreement, we will provide a cutting-edge turnkey solution to BMW, which includes hosting, equipment and management services, as well as private and hybrid cloud services, to support BMW's strong capacity needs in China.

For our Managed Network Services (MNS), we completed the divestiture of this business at the end of the third quarter. More importantly, we see the spin-off as a milestone in our development, as it enables us to re-focus our attention and resources to our core IDC business, strengthen our competitive advantages, and fortify our market leadership.

In summary, we are pleased with our accomplishment in the third quarter. We are leaner and stronger than ever before. We will fully focus on our core hosting and related services business, including IDC, cloud and VPN services. By leveraging our superior network speed, carrier- and cloud-neutral value proposition, and our highly endorsed service quality, we believe we will bring our business to the next level of growth.

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. 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.

First, I would like to discuss our financial highlights in the third quarter of 2017. Our total net revenues were 886 million, in-line with our guidance. More notably, consistent with our strategy of business realignment and cost control, our profitability in the third quarter continued to improve. Our adjusted EBITDA beat the upper end of our guidance of 122 million and reached 135 million in the quarter. We also saw an increase in our gross margin from 19.3% in the third quarter last year to 21.4% this past quarter.

Moving on to our MNS business, as Steve mentioned, we completed the divestiture of two business units on September 27, 2017. I would like to reiterate that the divestiture of our MNS business represents a milestone in our strategic realignment, which allows us to optimize our business structure, and refocus on our core IDC business. We expect our operating efficiency to continue to improve going forward. In addition, we will remain prudent on our cost and expenses and continuously enhance our cost reduction measures.

However, in conjunction with the divestiture, we experienced an impairment of long-lived assets of RMB 402 million, an impairment of goodwill of RMB 766 million, and disposal loss of subsidiaries of RMB 180 million, all of which were one-time non-cash items.

Furthermore, for the WiFire Entities, the 6 companies engaged in the CDN, hosting area network services, and route optimization businesses, 21Vianet and its joint venture partners are committed to inject up to RMB 100 million and RMB 200 million, respectively, into these entities within the next 12 months. The injections will be in installments, based on the business need of the WiFire Entities, and can be in the form of equity or a bridge loan, depending on the timing of the investment by the joint venture partners. As of November 2017, 21Vianet has already injected RMB 15 million and one joint venture partner has already injected RMB 30 million into the WiFire Entities.

Now let's take a closer look at our quarterly financial results. Our net revenues were 886 million, compared to 968 million in the prior year period and 879 million in the second quarter of 2017. Net revenues 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 9% to 759 million, compared to 699 million in the prior year period, and 743 million in the second quarter of 2017. The increase was mainly due to the increase in revenues from our business lines across the segment.

Our total monthly recurring revenue or MRR per cabinet for the third quarter increased to 8,571 from 8,311 in the second quarter of 2017.

Hosting MRR per cabinet for the third quarter increased to 7,817, from 7,615 in the prior year period and 7,697 in the second quarter. The main difference between total MRR and hosting MRR is that the former includes revenues from CDN.

Net revenues from managed network services were 127 million, compared to 270 million in the prior year period. The decrease was mainly due to increasing competition and pricing pressure.

Our adjusted gross profit was 221 million, compared to 225 million in the prior year period. Adjusted gross margin increased to 24.9%, compared to 23.2% in the prior year period.

Adjusted operating expenses improved by 21% year over year to 228 million, compared to 287 million in the prior year period. As a percentage of net revenues, adjusted operating expenses improved to 25.8%, compared to 29.7% in the prior year period.

Sales and marketing expenses improved by 23% year over year to 77 million, compared to 100 million in the prior year period. The improvement was mainly due to a decrease in third party channel costs.

General and administrative expenses improved by 20% year over year to 130 million, compared to 163 million in the prior year period. The improvement was mainly driven by a reduction in headcount.

Research and development expenses were 38 million, compared to 36 million in the prior year period.

Our Adjusted EBITDA increased to 135 million, compared to 68 million in the prior year period and 109 million in the second quarter of 2017. Adjusted EBITDA margin increased to 15.2% compared to 7.0% in the prior year period and 12.4% in the second quarter of 2017.

Adjusted EBITDA for our hosting and related services business increased by 41% year over year to 176 million compared to 125 million in the prior year period. Adjusted EBITDA for our MNS business was negative 41 million, an improvement of 28% compared to negative 57 million in the prior year period.

Adjusted net loss improved to 69 million, compared to 91 million in the prior year period. Adjusted net margin was negative 7.8%, compared to negative 9.4% in the prior year period.

Adjusted diluted loss per share was 10 cents, which represents the equivalent of 60 cents per ADS.

Turning to our balance sheet. Our cash and cash equivalents and short-term investment were 1.8 billion.

Now, let me provide you with our guidance. Starting from the fourth quarter of 2017, we will only provide guidance for our hosting and related services business, as we completed the spin-off of our MNS business.

For the fourth quarter of 2017, we expect net revenues from our hosting and related services business to be in the range of 740 million to 760 million, compared to 703 million in the prior year period. Adjusted EBITDA for our hosting and related services business is expected to be in the range of 160 million to 170 million, compared to 130 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.