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Q2 2020 21Vianet Group Inc Earnings Call

EVENT DATE/TIME: AUGUST 19, 2020 / 12:00PM GMT

CORPORATE PARTICIPANTS

Rene Jiang *21Vianet Group, Inc. - IR Director*
Shiqi Wang *21Vianet Group, Inc. - CEO & President*
Xiao Liu *21Vianet Group, Inc. - CFO*

CONFERENCE CALL PARTICIPANTS

Yang Liu *Morgan Stanley, Research Division - Vice President*
James Wang *UBS Investment Bank, Research Division - Research Analyst*
Colin McCallum *Crédit Suisse AG, Research Division - MD*
Zhenyang Chen *China International Capital Corporation Limited, Research Division - Analyst*
Edison Lee *Jefferies LLC, Research Division - Equity Analyst*
Chris Ko *DBS Vickers Research - Analyst*
Tina Hou *Goldman Sachs Group, Inc., Research Division - Equity Analyst*
Anna Zhang *T. ROWE PRICE*
Arthur Lai *Citigroup Inc., Research Division - Director & Analyst*

PRESENTATION

Operator

Good morning and good evening, ladies and gentlemen. Thank you, and welcome to 21Vianet Group Second Quarter 2020 Earnings Conference Call. With us today are Mr. Alvin Wang, Chief Executive Officer and President; Ms. Sharon Liu, Chief Financial Officer; and Ms. Rene Jiang, Investor Relations Director of the company.

I'll now turn the call over to your first speaker today, Ms. Rene Jiang, IR Director of 21Vianet. Please go ahead, ma'am.

Rene Jiang ***21Vianet Group, Inc. - IR Director***

Thank you, operator. Hello, everyone. Welcome to our second quarter 2020 earnings call.

Before we start, please note that 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.

I will now turn the call over to Mr. Alvin Wang, CEO and President of 21Vianet.

Shiqi Wang ***21Vianet Group, Inc. - CEO & President***

Thank you, Rene. Good morning and good evening, everyone. Thank you for joining us on our earnings call today.

Before I proceed with our second quarter results, I would like to take a moment to recognize the incredible resilience and courage that we have seen people exhibit around the globe in response to the pandemic. In addition, while our business and the IDC industry as a whole have remained largely insulated from the impact of COVID-19, we continue to be inspired on a daily basis by those working to support their families, neighbors and the communities in the face of the adversity. These acts provide all of us here at 21Vianet with hope, not only in the future and the potential for a bright tomorrow but also in the power of human ingenuity and compassion.

During the second quarter of 2020, we grew our revenues to RMB 1.14 billion and adjusted EBITDA to RMB 306.4 million, meeting both of our previous guidance ranges. This solid quarterly performance was primarily attributable to our expansion of total cabinet capacity as well as our improvements to the operating efficiency and utilization rates in the period.

We continued to pursue dual-core strategy and roll out of additional IDC capacity in the second quarter. Despite the second wave of

COVID-19 in Beijing, we delivered cabinets in accordance with our established delivery schedule and long-term growth plan. During the period, we delivered approximately 2,400 self-built cabinets in Jiangsu to 2 of our major wholesale customers and thus, continued to increase our organic growth trajectory. We also acquired over 2,000 wholesale cabinets in Shanghai.

Looking ahead, we remain confident in our ability to maintain our cabinet delivery schedule throughout the remainder of 2020 and achieve our total cabinet delivery target for the year. In addition, we kept the project that were already underway on track and continued to advance IDC projects on the partnership front during the second quarter. Consequently, the total signed wholesale MOUs has committed over 130 megawatts as of 30th of June, 2020.

On the retail front, we wrapped up the initial phase of our mission-critical production center for China Everbright Bank. Our carrier-neutral status, solid brand recognition and knowledge of large-scale and hyperscale IDC services remain attractive to renowned enterprises, and we look ahead to continue developing this type of partnership going forward.

From a broader perspective, we are optimistic about the market's long-term growth trajectory. As such, we plan to invest in those pipeline resources capable of delivering positive returns and improving our sustainable growth. Such disciplined execution requires a significant amount of planning and preparation. During the quarter, for example, we increased the power quota at our Jiangsu campus, which will support us during our second phase of development at this location.

In terms of market coverage, we also continued to explore potential business opportunities in Tier 1 and satellite cities during the second quarter. Our newly-secured brownfield sites in Hebei is in a promising location for future expansion initiatives. Based on the current plan, we will deliver over 2,000 cabinets at this site in the second half of 2021. Recognizing the ongoing trend of corporate digitalization across the country, we will continue to invest in these types of opportunities going forward to further expand our geographic footprint, increase our market share and make use of those opportunities that will emerge as a result of positive industry growth.

In summary, we continue to work in alignment with our long-term growth plans during the second quarter, expanding our cabinets capacity on schedule, enhancing our utilization rates and prudently allocating our resources towards those areas of the market with favorable growth perspectives. Looking ahead, we aim to continue exploring new opportunities to deliver our scalable services offerings, the solutions of which range from IDC to VPN and cloud. While the outbreak of COVID-19 has caused a certain amount of market uncertainty, we believe that our core value proposition remains attractive to enterprise partners and that we will be able to deliver increasing shareholder value over the long run.

Now I will turn the call over to Ms. Sharon Liu, CFO of 21Vianet.

Xiao Liu *21Vianet Group, Inc. - CFO*

Thank you, Alvin, and hello, everyone. Before we start our detailed financial discussion, please note that we will present non-GAAP measures today. Our non-GAAP results exclude certain noncash expenses which are not 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 unless otherwise stated, all the financial numbers we are presenting today are for the second quarter of 2020 and are in RMB terms and that percentage changes are on a year-over-year basis.

Despite the uncertainties in the macro environment, we concluded the second quarter with strong financial results while also keeping our cabinet delivery schedules on track, improving our operating efficiency and enhancing our utilization rate. As a result, in the second quarter, both our revenue and adjusted EBITDA met our previously announced guidance.

Revenue in the second quarter increased by 28.8% to CNY 1.14 billion from CNY 888 million in the same period of 2019. Such growth was mainly driven by the industry health growth trajectory and our ongoing capacity expansion which enabled us to address the uptick in the demand for hyper scale IDC solutions during the quarter. Retail IDC MRR per cabinet in the second quarter increased to CNY 8,953 from CNY 8,663 in the same period of 2019.

We added 4,404 new cabinets during the second quarter. This includes the recently acquired IDC in Shanghai, wherein over 95% of the cabinets are currently being utilized by a public cloud customer. The income that this IDC generates will contribute to our revenue and EBITDA starting immediately from the third quarter of 2020. As of June 30, 2020, we operated and managed 44,050 cabinets.

Despite our capacity expansion, compound utilization rate in the second quarter increased to 61.4% from 60.4% in the first quarter of 2020. More specifically, our utilization rate for those mature IDCs delivered prior to 2019 improved to 73.6% in the second quarter compared to 72.3% in the first quarter of 2020. At the same time, our utilization rate for those newly-built and ramp-up IDCs delivered since the start of 2019 improved to 30.1% compared to 12.3% in the first quarter of 2020. Our improved utilization rate was mainly due to our continuous delivery of additional cabinets in the period as well as shortened ramp-up period.

Adjusted cash gross profit in the second quarter, which excludes depreciation, amortization and share-based compensation expenses, was CNY 467.6 million compared to CNY 403.8 million in the same period of 2019. Adjusted cash gross margin was 40.9% compared to 45.5% in the same period of 2019. The decline in margin on a yearly basis was due to the delivery of additional IDC capacity.

Adjusted operating expenses in the second quarter, which exclude share-based compensation expenses, increased by 13.1% to CNY 182.5 million from CNY 161.3 million in the same period of 2019. As a percentage of net revenues, adjusted operating expenses decreased to 15.9% from 18.2% in the same period of 2019, demonstrating our improvement to operating leverage and efficiency.

Adjusted EBITDA in the second quarter grew by 17.5% to CNY 306.4 million from CNY 260.7 million in the same period of 2019. Adjusted EBITDA margin decreased to 26.8% from 29.4% in the same period of 2019 due to the delivery of additional capacity.

Net loss attributable to ordinary shareholders in the second quarter increased to CNY 2.12 billion from CNY 102.1 million in the same period of 2019. Net loss attributable to ordinary shareholders in the second quarter included changes in the fair value of convertible promissory notes of CNY 1.61 billion due to the rapid rise in the company's stock price and deemed distribution of CNY 470.6 million from the issuance of Series A perpetual convertible preferred shares, which were both non-operating related and non-cash loss.

Basic and diluted loss was CNY 3.21 per ordinary share and CNY 19.26 per ADS, respectively. Each ADS represents 6 ordinary shares.

Moving on to our balance sheet and liquidity. At the end of the second quarter, our debt-to-assets ratio was 74.7%. Taking out the effect of the changes in the fair value of convertible promissory notes, our debt-to-adjusted-EBITDA rate was 4.7.

Net cash generated from operating activities was CNY 161.8 million in the second quarter. As of June 30, 2020, we recorded a cash position of CNY 4.98 billion. Earlier this month, we paid the remaining USD 131 million of our 2020 bond.

During the quarter, we explored a diversified range of financing resources to continue fueling our long-term business growth. In addition to securing those opportunities available in the current banking environment, which is quite favorable to Chinese IDC industry, we also entered into a USD 200 million private placement deal with a group of investors led by Goldman Sachs and received additional USD 150 million investment from funds managed by Blackstone. Going forward, we will maintain our focus on the execution of development initiatives that are both prudent and cost-efficient. In addition, we will also continue to explore different financing channels to further strengthen our balance sheet, support our business growth and accelerate our expansion of services in key markets over the long term.

To better support the company's organic growth, acquisition efforts and achievement of its delivery targets for 15,000 cabinets by the end of the year, we are planning for CapEx to be between RMB 3 billion and RMB 3.4 billion in 2020, which is in line with our 3-year growth plan. Looking ahead, we expect net revenue for the third quarter of 2020 to be in the range of CNY 1.23 billion to CNY 1.25 billion and adjusted EBITDA to be in the range of CNY 340 million to CNY 360 million. For the full year of 2020, we now expect net revenue to be in the range of CNY 4.7 billion to CNY 4.9 billion and adjusted EBITDA to be in the range of CNY 1.28 billion to CNY 1.38 billion. This forecast reflects our current and preliminary views on the market and operational conditions, which are subject to change and do not factor in any of the potential impact that could be caused by the COVID-19 epidemic in the future.

This concludes our prepared remarks for today. Operator, we are 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 - Vice President***

Congratulations on solid results and the upward revision of the full year revenue and EBITDA guidance. I have 2 questions here. First, compared with the first quarter when the company mentioned that you have 90 megawatts MOU for wholesale, I think the company added 40 megawatts in one single quarter. If I do the calculation, that is around 5,000 cabinets versus full year guidance of wholesale cabinets net at 6,000, so -- which means that it's very strong, solid and almost occupy more than 80% of the full year target. I would like to ask what is the contribution from the M&A in Shanghai in the 40 megawatts and also how sustainable such kind of very strong wholesale demand can sustain -- how sustainable is the demand.

And my second question is that the company also disclosed 2 new projects. One is Shanghai JQ and the other is HeBei II. Could you please elaborate more about the potential future for -- especially for HeBei II, given it's a brownfield project and whether it will be for the wholesale or retail customer? And what is the current indication from the customer in terms of demand?

Shiqi Wang ***21Vianet Group, Inc. - CEO & President***

Thank you, Liu Yang. It's Alvin here. Thank you for your question. Regarding the demand from wholesale customers, actually, as we disclosed, we have committed customer demand of 130 megawatts, which includes 10 megawatts from merger and acquisition in Shanghai and the others are mainly from customer demand on our ongoing projects. And actually, we do see very strong customer demand not only from the top leading cloud operators but also some other leading Internet players and also some other big enterprises as well. So we do see a strong pipeline not only in Shanghai and Beijing but in some other places as well, especially in some satellite cities of these top-tier markets.

And to your second question about our new sites in the Hebei province, actually, this site is in a quite good location, which is very nearby to Beijing City area, which there is very high-quality network connection. And also, we do see very strong customer demand. Actually, we already have very kind of promising customer demand from more than one customer. So we do expect that we will deliver these projects to our customers second half of next year.

And your second question also mentioned our site in Shanghai, right?

Yang Liu ***Morgan Stanley, Research Division - Vice President***

Yes, Shanghai JQ project and HeBei II. Yes, I think you have already covered that.

Shiqi Wang ***21Vianet Group, Inc. - CEO & President***

Yes. Actually, the Shanghai JQ project is actually -- the project, as Sharon mentioned, which is a newly acquired data center, which is a very high-quality data center for one of our leading wholesale customers. It's with very high utilization rate. Thank you.

Xiao Liu ***21Vianet Group, Inc. - CFO***

Yes. Liu Yang, this is Sharon. Yes, I will add more color on the 2 projects. For the Shanghai JQ project, we acquired by the end of Q2 and we will start to recognize revenue and EBITDA from Q3. And this data center is a mature data center and the utilization rate is around 95% with around 10 megawatts.

And for the HeBei II project, the total power capacity is around 20 megawatts, and we are targeting to deliver this data center in next year and the targeted customers is the wholesale customers. And as Alvin mentioned, we now have more than one customer.

Shiqi Wang ***21Vianet Group, Inc. - CEO & President***

Very strong demand.

Xiao Liu ***21Vianet Group, Inc. - CFO***

Very strong demand from the customer. And for the customer demand, if you see the utilization rate we disclosed for the existing data center as well as the newly built and ramp-up cabinet, the utilization rate increased in Q2, thus demonstrated our increasing demand from both wholesale and retail customers.

Yang Liu ***Morgan Stanley, Research Division - Vice President***

Can I follow up a very quick question? Could you please disclose or talk about the valuation multiple for the Shanghai JQ project. We know that maybe the private market, actually, the valuation is also getting higher. Not sure -- or how should we think about how accretive this project is?

Xiao Liu ***21Vianet Group, Inc. - CFO***

As we mentioned before, our targeting multiple is 6 to 8 for the mature data center acquisition, and this project is within that range. Thank you.

Operator

Our next question comes from the line of James Wang from UBS.

James Wang ***UBS Investment Bank, Research Division - Research Analyst***

I've got 2 questions. So first question is on the MRR. So I've noticed that it's risen about 3% in the second quarter year-on-year. So just wondering what are the main drivers. And what's your outlook for MRR over the next 1 to 2 years as your wholesale customers -- or the percentage of wholesale business grows?

And for the new entrants coming into the market, I just want to get a sense of what sort of pricing are they offering versus your current pricing. Are they discounting heavily to grab customers? So that's the first question on the MRR outlook.

And the next question is just on operating expense. So I've noticed operating expense as a percent of revenue has come down about 3 percentage points year-on-year. Can you give us a sense of, over the next 1 to 2 years, how low this ratio can get to, whether you have any internal target?

Xiao Liu ***21Vianet Group, Inc. - CFO***

Okay. Thank you for your question. Regarding your question 1 on the MRR, the driver of the increase in this quarter was because we signed a new contract with a financing customer with higher MRR as well as more value-added service provided to our existing customers. And in the next 1 or 2 years, we expect the MRR per cabinet for retail business will be stable.

And compared with the other new entrants, I think we provide different products to them. For the new entrants, they always provide colocation and power. But for 21Vianet, as we provide more value-added service, including interconnectivity and hybrid - IT hybrid cloud services to those customers, we can achieve more -- higher MRR per cabinet. And also, the value-added services help us to increase the stickiness of our customers.

Your question 2 is relating to the operating expenses rate. Of course, we have achieved operating leverage since year 2018 after we refocused on the IDC business. And this year, we expect the operating expenses rate will be around 15% for the whole year. And in the midterm, we are targeting to 14% to 15% of the operating rate as a percentage of revenue. We will continue to improve our operating efficiencies. Thank you.

Operator

Our next question comes from the line of Colin McCallum from Crédit Suisse.

Colin McCallum ***Crédit Suisse AG, Research Division - MD***

My question was just regarding the -- thinking ahead to the cabinet additions for 2021. I'm quite clear on your 2020, but just thinking about next year. I think you had -- maybe had a problem on the power allocation on one of the projects that was in your stated pipeline.

Are you still confident you can do 15,000 for next year? Or indeed, can you give us any revised guidance that, that could be a higher number? Obviously, I'm looking for what your cabinet guidance is that you feel confident that you have both the land and the power allocation sorted out already.

Shiqi Wang ***21Vianet Group, Inc. - CEO & President***

Thank you for the question, Colin. It's Alvin here. Regarding our capacity expansion plan for the next year or so, at this moment, still, we keep our original 3-year growth plan, which is around 15,000 cabinets next year. And we do have very strong resources pipeline, especially in our focusd markets, Tier 1 cities and also satellite cities around these areas.

So we do have a very strong confidence going forward. And we will update our capacity expansion plan in the coming quarters. Thank you.

Operator

Our next question comes from the line of Zhenyang Chen from CICC.

Zhenyang Chen ***China International Capital Corporation Limited, Research Division - Analyst***

This is Chen Zhenyang from CICC. Congrats on the strong results. I have 2 questions. First one is about our margin. We see visible margin improvements quarter-over-quarter in the second quarter. And I'm wondering how the margin's like looking forward, given more wholesale business in our total revenues.

And the second question is about our future IDC expansion. We noticed some new financing options in the market like REITs or building joint venture or using some asset-light models. Would we consider this kind of different ways in our future expansion?

Xiao Liu ***21Vianet Group, Inc. - CFO***

Zhenyang, thank you for your question. Regarding -- to your question 1 about our margins, this quarter, our adjusted EBITDA margin improved. That was because of the improvement of our utilization rate of both existing and new delivery and ramp-up data centers. And if you're looking at the guidance we provided to the market, the adjusted EBITDA will be -- for this year will be in the range of 27% to 28%. And we believe we will be achieving a longer upward trend supported by the utilization improvement and future operating leverage going forward.

Your question 2 regarding to -- the financing channels, of course, as an asset- and capital-intensive industry, we are targeting to diversify our funding channels, including the project financing, bond as well as the C-REITs or the joint ventures with potential strategic cooperators to support our future expansion plans. And we also noted that the NDRC and CSRC has announced detailed instruction on the C-REITs. We may consider that financing channel, but currently, they're -- we have no definitive timetable for the project.

Operator

Our next question comes from the line of Edison Lee from Jefferies.

Edison Lee ***Jefferies LLC, Research Division - Equity Analyst***

Congratulations on the results. I have 2 questions. Mainly -- both of them are on capacity expansion and demand and supply.

So for 2021, your plan is 15,000 cabinet expansion. And based on the supply and demand that you have seen over the past 6 months after the government is pushing new infrastructure, do you think that supply or demand, which side is actually better than expected? Or actually, would it be that supply is -- well, supply meaning the supply of projects, right, and demand is coming from your assessment by talking to customers. So can you maybe give us some color on what do you think demand has changed and supply has changed over the past 6 months?

Shiqi Wang ***21Vianet Group, Inc. - CEO & President***

Okay. Thank you for your question. This is Alvin here. So regarding the capacity expansion plan, we -- as we mentioned before, still we keep our 3-year growth plan. This year, we will deliver more than 15,000 self-built. And next year, we -- currently, our plan is also the same level.

And also, we do see very strong customer demand, especially after this COVID-19 breakout. So we do see the digital transformation is accelerating and also that we see very strong demands from end users as well. And especially in top-tier cities, we do see very strong customer demand.

And at the same time, we also expect some newcomers with new investments to enhance the supply side as well. But we do see the very kind of strong supply -- sorry, the demand side, especially in Tier 1 cities, which is -- which are the major -- our focusd markets. So we still keep a very strong confidence that we will meet this strong customer demand in these focus markets.

Edison Lee ***Jefferies LLC, Research Division - Equity Analyst***

And let me ask a follow-up question. Do you see more greenfield projects or do you see more acquisition opportunities? What is the mix, you think?

Shiqi Wang ***21Vianet Group, Inc. - CEO & President***

Do you mean for our own or for the market?

Edison Lee ***Jefferies LLC, Research Division - Equity Analyst***

For your own.

Shiqi Wang ***21Vianet Group, Inc. - CEO & President***

Yes. For sure, we -- our growth was mainly driven by our organic growth. At the same time, we do see -- keep very close eyes on some very good acquisition opportunities. But for sure, organic is the mainstream.

Operator

(Operator Instructions) Our next question comes from the line of Chris Ko from DBS.

Chris Ko ***DBS Vickers Research - Analyst***

Congratulations on the strong results. And I've got 2 questions. First is for the cabinets coming online in the second half this year, is there a pre-committed rate? Or could you share some color on the move-in pace?

And the second question is, I would like to follow up on the 40-megawatt wholesale contract increase. Was it mainly driven by new wholesale customers or existing customers? And what are the projects accounting for the new net adds? And do we have the time line for the new net adds?

Shiqi Wang ***21Vianet Group, Inc. - CEO & President***

Thank you, Chris, for your question. It's Alvin here. Regarding the expansion plan for the second half, we see very strong -- we have very strong confidence we will deliver the new capacity to reach our yearly target. And also from the demand side, as I mentioned before, we do see very strong demand, especially in the Tier 1 cities and also the satellite cities around these areas. And we do have a very strong customer demand pipeline. And so we will have -- we will improve our utilization rates in the coming quarters as well.

And regarding our wholesale customers, we do have a very strong relationship with our top wholesale customers, not only one but a few ones. And going forward, we will expand our customer base in the wholesale segment as well. Thank you.

Operator

(Operator Instructions) Our next question comes from the line of Tina Hou from Goldman Sachs.

Tina Hou ***Goldman Sachs Group, Inc., Research Division - Equity Analyst***

This is Tina Hou from Goldman Sachs. I have 3 questions. The first one is that regarding our revenue and EBITDA guidance rate in 2020. I was wondering if this is purely due to the acquisition of Shanghai JQ project. Or are you seeing higher momentum in terms of the organic part of the business as well? And also regarding Shanghai JQ, management mentioned that this is for like a wholesale customer. I was just wondering if this is an existing wholesale customer or a new wholesale customer.

And then my second question is regarding our FY 2021 expansion pipeline. Out of the 15,000 cabinets, just wondering what is our pre-commitment or commitment rate from customers. And then last question is wondering if we have any new customer wins, both for the wholesale as well as for the retail side, that you can share with us.

Xiao Liu ***21Vianet Group, Inc. - CFO***

Thank you, Tina, for your questions. Regarding our new guidance, we raised the full year guidance because of 2 reasons. One is the acquisition of Shanghai JQ project. Another reason is because of the higher momentum from our customers as well as the shorter ramp-up in our certain data centers.

For your question #2, the JQ customer is one of our existing wholesale customers. And for your question 3 regarding our 2021 cabinet expansion plan, around 40% was pre-committed by the wholesale customers. But in the future, we may receive more MOUs with potential wholesale as well as the retail customers from financial sectors. Thank you.

Operator

Our final question today comes from the line of Anna Zhang from T. ROWE PRICE.

Anna Zhang ***T. ROWE PRICE***

I have 2 questions. The first one is on the balance sheet. I just want to clarify the 3 billion convertible promissory note. Is it just the 200 million CB on -- to GS and the rest of the amount is just the fair value change in the quarter?

And the second question is that -- we understand that there is divesting cost in the CB and also preferred share of Blackstone. So I'm just wondering if you have a concrete plan on the secondary listing in Hong Kong.

Xiao Liu ***21Vianet Group, Inc. - CFO***

Okay. Regarding your question 1, the answer is yes. And regarding the question 2, as I mentioned before, we are targeting to diversify our funding channels and we consider all kinds of financing channels, like the project financing debt, secondary listing, C-REITs and other joint ventures with the strategic cooperators.

Anna Zhang ***T. ROWE PRICE***

I just want to -- so you guys are currently in talks with banks and lawyers regarding the secondary listing, right, but it's just no concrete plan yet?

Shiqi Wang ***21Vianet Group, Inc. - CEO & President***

We are not ruling out any options at this moment, but we have no kind of concrete timetable for any options at this moment.

Operator

We can take one more question from the line of Arthur Lai from Citi.

Arthur Lai ***Citigroup Inc., Research Division - Director & Analyst***

I would like to ask -- we see loss in the -- this quarter due to the convertible promissory notes due to the rising company stock price. Just wondering is that a one-off or if the stock price keeps rising, then we might have some of the losses as well in third quarter or in the future.

Xiao Liu ***21Vianet Group, Inc. - CFO***

Okay. Actually, for the CB, in accordance with certain terms we signed with the investors, according to the accounting treatment, we should recognize the balance as a mark-to-market basis. So that will be fluctuated in each quarter until the investor converts the CB into our ordinary shares. Thank you.

Operator

I'll now turn the call back to management team for the closing remarks. Please go ahead.

Rene Jiang *21Vianet Group, Inc. - IR Director*

Thank you once again for joining us today. If you have any further questions, please contact the company's IR through the website. Thank you. Good day.

Operator

Ladies and gentlemen, that does conclude our conference for today. Thank you for participating. You may all disconnect.