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Q4 2017 21Vianet Group Inc Earnings Call

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PRESENTATION

Operator

Good morning, and good evening, ladies and gentlemen. Thank you, and welcome to 21Vianet Group's Fourth Quarter and Full Year 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 selected events or circumstances after the date of this conference call.

With us today are Mr. Steve Zhang, co-Chief Executive Officer; Mr. Alvin Wang, co-Chief Executive Officer and President; and Ms. Sharon Liu, Chief Financial Officer. At this time, I would now like to turn this call over to Mr. Steve Zhang, co-CEO of 21Vianet. Please proceed, sir.

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

Thank you, operator. Good morning, and good evening, everyone. Thank you for joining us for the earnings call today. I want to first start by welcoming Alvin to 21Vianet. He has a wide experience in the telco industry, and his expertise will prove invaluable to 21Vianet. Alvin, would you like to say a couple of words?

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

Thank you, Steve. Hello, everyone. This is Alvin, Wang Shiqi. I'm honored and excited to join 21Vianet's management team and then talk to you all today. Having spent over 20 years in the telecom industry and having worked closely with VNET's board for more than 1.5 years, I'm looking forward to putting my experience, expertise and then contacts to work inside the company.

At this moment, I would like to turn the call back to Steve to remark on Q4 and the 2017 full year results.

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

Thank you, Alvin.

2017 was an exciting year for the company, one that was full of change but also new opportunities. We were able to restructure the company by optimizing and then ultimately divesting our loss-making MNS business. We were also able to raise $300 million through a bond offering to support our growing hosting business. We faced numerous challenges along the way but were able to maintain our focus on our long-term goals and coming to 2018 revitalized and then stronger. Looking forward, I'm excited for all the new opportunities in our business. As public cloud adoption becomes more widespread, our customers are employing more complex IT architectures, utilizing hybrid IT and hybrid cloud infrastructures, which presents us with fantastic growth opportunities.

Moving on to our business, we are pleased to report another quarter of solid growth in both our top line and profitability. For the fourth quarter, revenue for our core hosting and related services business increased by 9% and adjusted EBITDA increased by 229%. For our core business, we increased the number of our self-built cabinets by 2,550 this past quarter, while at the same time decreasing our lower-margin partnered cabinets by 894 cabinets, bringing the total cabinets under management to 29,080 cabinets. Of the 894 reduced partnered cabinets, 570 were removed due to the MNS spin-off.

In anticipation of future market demand and the limited prime real estate resources in Tier 1 cities in China, we entered into an agreement with Tus for a land parcel in Songjiang, Shanghai, where 2 buildings are being planned for data center use. Upon completion in the middle of 2019, the 2 buildings are expected to have a capacity of around 3,000 cabinets for our clients in Shanghai.

During the fourth quarter of 2017, we expanded our client base, including new relationships with Meitu, Douyu, Tujia and the 99Bill and the BoHai life insurance. At the same time, we have also seen increased demand for cabinets based from our existing clients as well, including Xiaomi, Momo, Huawei and the Lianjia.

On the cloud side, we witnessed the continued migration of China's Internet companies and enterprises from public cloud to hybrid cloud and the rising demand for customized cloud solutions. To capture this growing demand, we broadened and customized our service offerings to cater to our customers' specific requirements. For example, we recently entered into a partnership with a global shipbuilding company. The company will build luxury cruise ships for the China market and will require a complex hybrid IT infrastructure for the ships. 21Vianet will provide a mixture of Microsoft cloud services, IDC services and technical support to the company. The initial term will be for multiple years, with revenue contribution of roughly CNY 24 million. Together with our unique competitive edge of being carrier- and cloud-neutral, we're well positioned to capitalize on these opportunities and to consolidate our leading position in this blooming Chinese market.

We were also able to establish new and exciting partnerships while expanding our old ones during the past year. For example, we've strengthened our cooperation with both AliCloud and Tencent Cloud by building out direct fiber lines between certain 21Vianet data centers and those of Alibaba and Tencent. This will enable us to offer public cloud connectivity to our customers as well as assist them in building out their hybrid cloud infrastructure.

Overall, we are pleased with the results of our business, restructuring and strategy shifts during the past year. Looking ahead into 2018, we'll continue to fully focus on our core business and with our lean asset-light approach, we are confident that we will accelerate our growth amid the evolving demands of our customers.

As you are all aware, in January this year, we promoted Ms. Sharon Liu to the position of Chief Financial Officer. Sharon has been with us for over 7 years serving as Vice President of Finance prior to her promotion. We believe that Sharon's experience and expertise in corporate finance management, M&A and Investor Relations will help our team manage our aggressive goals for growth in the years ahead.

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

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

Thank you, Steve, and hello, everyone. I'm pleased to talk to you as the CFO of 21Vianet. Before I begin, I'd like to say that we will present non-GAAP measures today. Our non-GAAP results exclude certain noncash expenses, which are not a part of our core operation. The details of these expenses may be found in the reconciliation table included in our press release. Please note that all the financial numbers we are presenting today are in RMB, and the percentage change are year-over-year, unless otherwise noted.

As Steve mentioned earlier, we completed the divestiture of MNS business in the third quarter of 2017, which has allowed us to shed an extensive financial burden, improve our cost structure and to focus all our resources on our core business. As we move towards a leaner business structure, we expect financial and operating metrics to show continued improvement.

Now let me walk you through our fourth quarter 2017 financial highlights. After the MNS spin-off, our income statement only represents the hosting and the related services business.

Net revenue were CNY 766 million compared to CNY 703 million in the prior year period, excluding the MNS business. The increase was mainly due to the increase in total billable cabinets attributable to growing customer demand on IDC and hybrid IT services. Hosting MRR per cabinet for the fourth quarter were CNY 7,766 compared to CNY 7,878 in the prior year period and CNY 7,817 in the third quarter. Our adjusted gross profit were CNY 211 million compared to CNY 222 million in the prior year period, which includes the MNS business. Adjusted gross margin increased to 27.6% compared to 24.7% in the prior year period. The margin expansion was primarily due to the company's execution of cost control strategies.

Adjusted operating expenses were CNY 173 million compared to CNY 310 million in the prior year period. As a percentage of net revenues, adjusted operating expenses were 22.6% compared to 34.4% in the prior year period.

Sales and marketing expenses improved to CNY 43 million compared to CNY 92 million in the prior year period. The improvement was mainly due to the MNS spin-off.

General and administrative expenses improved to CNY 115 million compared to CNY 187 million in the prior year period. The improvement was mainly due to the MNS spin-off and a reduction in headcount.

Research and development expenses improved to CNY 29 million compared to CNY 38 million in the prior year period. The improvement was mainly due to the MNS spin-off.

In December last year, we also announced the complete divestiture of all remaining equity interest in Aipu and the elimination of the Aipu put option. This resulted in a noncash gain of CNY 677 million, however, as it's removed from our adjusted EBITDA.

Adjusted EBITDA increased to CNY 171 million compared to CNY 52 million in the prior year period. Adjusted EBITDA margin increased to 22.3% compared to 5.8% in the prior year period. Adjusted EBITDA for hosting and related service business was CNY 171 million compared to CNY 113 million in the prior year period, excluding the MNS business. The increase was primarily due to revenue growth as well as improving cost control and operating efficiencies.

Adjusted net gain improved to CNY 52 million compared to a loss of CNY 71 million in the prior year period. Adjusted net margin was 6.7% compared to negative 7.8% in the prior year period.

Adjusted diluted gain per share was CNY 0.08, which represents the equivalent of CNY 0.48 per ADS.

Turning to our cash flow and balance sheet. We generated CNY 106 million of positive cash flow from operating activities during the fourth quarter. Our cash and cash equivalents and short-term investment were CNY 2.5 billion as of December 31, 2017.

Now let me provide you with our guidance. Our guidance for 2018 will only reflect hosting and related services.

For the first quarter of 2018, we expect net revenues to be in the range of CNY 770 million to CNY 790 million. Adjusted EBITDA is expected to be in the range of CNY 178 million to CNY 190 million. For the full year 2018, we expect net revenues to be in the range of CNY 3.25 billion to CNY 3.35 billion. Adjusted EBITDA is expected to be in the range of CNY 750 million to CNY 830 million.

Now I'd like to hand the call back over to Alvin for closing remarks.

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

Thank you, Sharon. I'd like to take this opportunity to briefly share our company's strategy going forward. As we previously communicated, we will refocus on our core business, IDC and the related service, cloud computing operations and VPN services.

In regards to IDC and the related services, we view the market as having retail and wholesale segments. In order to defend our leading position and gain market share in the retail segment, we will continue to increase our supply capacity in Tier 1 and the selected Tier 2 cities. We will continuously optimize our operational efficiency. Our increasing hybrid IT cloud capability also gives us competitive advantage, and it creates greater value for our customers as well as increasing stickiness.

And for the wholesale market, by leveraging our major stakeholders and the strategic partners, we are building up our capabilities and the customer base in this segment. We already have numerous wholesale projects in our pipeline, most of which will come online in 2019. Also, for this year, we are going to implement performance-based stock units for senior executives and the key employees, which will focus on KPIs such as revenue, EBITDA and the share price.

With our realigned strategy in place, strong support from major stakeholders and our fully motivated team, we are confident and ready to embrace the growth opportunities going forward.

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 Yang Liu from Morgan Stanley.

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

I have 4 questions here. The first one, I see the company accelerated in the new data center deployment in the fourth quarter last year, but the utilization was held up well at above 75% level. I would like to ask, did you see some improvement at the demand side and a faster ramp-up of the utilization? The second question is could the management team provide more details on 2018 cabinet addition details like location and the scale as well as the CapEx plan for the new additions? The third question is I think the 2018 EBITDA guidance implies a good sequential improvement of margin. And what is the key driver for the around 2 percentage point of uplift? Is it due to mix shift to self-built, or is it due to the better utilization? The last question is related with the restricted cash and the prepaid expense. I see some changes in the fourth quarter balance sheet compared to the third quarter. Could you please elaborate more on that?

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

Okay. Thanks. I will take a shot at the first question. You -- yes, in the fourth quarter, towards the end of the fourth quarter, we are finished delivering 2 data centers, one in Guangzhou and one in Beijing, with capacity roughly 2,500 cabinets. And when we calculate our utilization rate, we use a time-weighted average to calculate our capacity. So looking at the utilization rate, the newly added cabinets was now fully reflected in -- when we calculate the utilization rate. And we are basically -- expect our utilization rate in the first quarter will drop a little bit because those newly deployed cabinets will be reflected in our first quarter 2018. And Shiqi, do you want talk about the cabinet capacity, the CapEx?

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

Actually, it's -- in the coming year, that our overall plan is that we will increase our capacity of self-built cabinets to around 3,000 to 4,000. The details for this cabinet addition will be fully confirmed through the year because we will see -- according to the customer demand and also according to the progress of the build-up. So currently, we don't have the detailed information regarding the locations and the capacity in the east side, but overall, that we have a very strong confidence that we will add the new capacity in Tier 1 and Tier 2 cities in the coming year.

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

Our CapEx for 2018 will be roughly in the range of CNY 400 million to CNY 500 million. For your third question, what's the margin expansion -- what's driving the margin expansion for 2018? Number one, as you said, we are moving toward a more self-built data center in our product mix, which have a higher margin. The second driver will continue to bump up our utilization rate in both our self-built data centers as well as partnered data centers to drive the operational efficiency. Sharon will answer your question about -- can you repeat your fourth question about restricted cash?

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

Yes. Sure. I think compared with the end of the third quarter last year, I see a drop in both restricted cash and the prepaid expense in your balance sheet current asset. So could you please elaborate more about the change here?

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

Okay, Yang, I will answer this question. The prepaid expenses and the other current assets in Q3 included the USD 1 million bond with that contract -- USD 100 million bond. We signed a contract that we receive the money in October. So at the end of Q3, the balance was recorded in prepaid expenses. And after we got all the USD 300 million as the company planned, we used the proceed from the bond offering to repay a CNY 1.6 billion bridge loan in December. And this, in return, freed the same amount restricted cash we had on our balance sheet. That's why our restricted cash dropped a lot during Q4.

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

Okay. Sorry for one more question related with management's incentive plan. Could you please elaborate more about potential timing and the structure of the KPI target, et cetera? That's my last question.

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

Our board approved a plan, a restricted stock plan. Internally, we call it PSU, performance stock unit. It will be granted in the next quarter or next 2 quarters. But the performance target associated with this group of performance stock units are mostly EBITDA target, revenue target as well as future stock price target.

Operator

(Operator Instructions) If there are no further questions, I will hand back to management for closing remarks. It looks like we've had 2 questions come through before we go to closing remarks. Our next question will come from Isaac Lai from China Life.

Isaac Lai

I have 3 questions. The first one is regarding the dividend policy because the company is on a growth phase, so in the past, it was also making loss (inaudible) dividend. But going forward, is there any change in the dividend policy? And this is the first question. And the second one is regarding the high cash level the company is having. I noticed that the company's competitor is, like the TDS, is adding their floor quite aggressively. So -- and the company now is having like a very high cash level, so -- which is much higher than the CapEx plan in the next 1 or 2 years. So will there be any plan for acquisition? And the third question is regarding the increase in the short-term and long-term investments on the balance sheets. Can you elaborate a little bit more on these short-term and long-term investments? And what are the company's financial products? So these 3 questions mainly.

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

So your first question is our dividend policy? I didn't hear you quite clearly.

Isaac Lai

Yes, regarding the future dividend policy.

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

Currently, our board doesn't have any plan to issue any dividend going forward. At least in the next 2 years, we don't have any plan for -- to issue any dividend. Your second question is about our CapEx and the cash on our balance sheet. We still have a pretty aggressive plan to expand our data center capacity because the market is growing quite fast, and we are working with our partners like [Huaping] and other partners, negotiating and finalizing several projects. And we are also -- the company ourself is looking to how -- like I have mentioned, roughly CNY 400 million to CNY 500 million CapEx plan this year going forward to build our data center capacity. What's your third question?

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

I will answer your third question about our short-term and long-term investment. Our short-term investments represented the bank deposit over 3 months but within 1 year, so the increase was mainly due to our cash management policy. And the long-term investment increase was due to our joint venture of Warburg Pincus.

Isaac Lai

Okay. Good. For the second question, I mean, I know that because the cash level right now is like CNY 2 billion and then the CapEx plan next year is around CNY 500 million -- CNY 400 million to CNY 500 million, so that's still quite a huge cash on the balance sheet. So you mentioned the partnership. So after that partnership, will this lead to a maybe more significant change in that cash balance?

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

Hello. This is Alvin. May I answer your question? Actually, our current CapEx plan doesn't reflect -- only reflects our self-built cabinet CapEx in the coming year. And actually, we have a few wholesale projects ongoing, but there's a big uncertainty in terms of timing and in terms of the locations, and also which means that in the coming years, that with our existing cash, we will have -- we will strengthen our wholesale capability, which means that the CapEx from a wholesale perspective will require a very heavy investment. But we cannot confirm the timing, that's why we didn't include into our current CapEx guidance. And also, for sure, that we are open to any M&A opportunities if we -- our assessments reflect -- if we -- after assessments, we think that it will be a good deal and it will increase our competitive advantage, especially in the Tier 1 and Tier 2 cities.

Operator

Our next question comes from [Rex Feng] from [SPQH Capital].

Unidentified Analyst

I have 2 questions. First is, is there an EBITDA target related to your options scheme -- I mean, the management, the incentive scheme? Second question regarding the M&A and also the wholesale business you were talking about. Can you share with us more about the strategy and the plan there?

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

Yes. As I mentioned, that our performance stock unit, a big weight is put on the EBITDA target we'll achieve in the next 2 to 3 years. Your second question is about our wholesale and M&A? As Alvin just said, we are working on several projects for the wholesale product. I think on one end, we are discussing with several large customers for the sales pipeline because we would like to secure a letter of intent for those projects. On the other side, we are, ourself, as well as our joint venture regarding our negotiating and the finalizing the negotiations with several properties to be converted into our wholesale data centers.

Unidentified Analyst

Just a couple of questions regarding the EBITDA target. Is that in line with your quarterly, I mean, the previous? For example, if that EBITDA target in line with your first quarter '18's EBITDA target guidance?

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

The EBITDA targets in our performance stock units will be multiyear targets, so it will be higher than our current guidance.

Operator

(Operator Instructions) There are no further questions. I will hand back to management for their closing remarks.

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

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. Thank you.

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

Thank you.

Operator

Thank you. Ladies and gentlemen, that does conclude our conference for today. Thank you so much for your attendance. You may all disconnect.

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