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Q3 2022 VNET Group Inc Earnings Call

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PRESENTATION

Operator

Hello, ladies and gentlemen. Thank you for standing by for the Third Quarter 2022 Earnings Conference Call for VNET Group, Inc. (Operator Instructions)

Participants from our management include Mr. Jeff Dong, Chief Executive Officer; Mr. Tim Chen, Chief Financial Officer; and Xinyuan Liu, Investor Relations Director of the company. Please note that today's conference call is being recorded.

I will now turn the call over to the first speaker today, Ms. Xinyuan Liu. Please go ahead.

Xinyuan Liu ***VNET Group, Inc. - Investor Relations Director***

Thank you, operator. Hello, everyone, and welcome to our third quarter 2022 earnings conference call. Our earnings release was distributed earlier today, and you can find a copy on our IR website as well as our newswire services.

Please note that the discussion today will contain forward-looking statements made under the safe harbor provisions of the U.S. Private Securities Litigation Reform Act of 1995. Forward-looking statements are subject to risks and uncertainties that may cause actual results to differ materially from our current expectations. For detailed discussions of these risks and uncertainties, please refer to our latest annual report and other documents filed with the SEC. VNET does not undertake any obligation to update any forward-looking statements, except as required under applicable laws.

Please also note that VNET's earnings press release and this conference call include the disclosure of unaudited GAAP financial measures as well as unaudited non-GAAP financial measures. VNET's earnings press release contains a reconciliation of the unaudited non-GAAP measures to the unaudited GAAP measures.

As a reminder, this conference is being recorded. In addition, a webcast of this conference call will also be available on our IR website at ir.vnet.com.

I will now turn the call over to our CEO, Jeff.

Jeff Dong ***VNET Group, Inc. - President & CEO***

Thank you, Xinyuan. Good morning, and good evening, everyone. This is Jeff. It's a great pleasure to meet and speak with all of you today. I'm deeply honored to take on the role of CEO and excited to explore the great opportunities and prospects ahead for VNET. I look forward to leveraging my cross-industry expertise and working closely with our talented team to drive the company's dual-core growth strategy and cement our commitment to delivering sustainable, long-term value to our shareholders.

I'd like to start with an overview of our third quarter performance. Against the backdrop of the mounting macroeconomic headwinds, we remain focused on fulfilling market demand for high-quality and reliable IDC services. By the end of the third quarter, we had grown total cabinets under management to 82,660 from approximately 65,300 1 year ago. At the same time, cabinets utilized by customers increased sequentially by 1,027 to approximately 45,530 compared to approximately 38,300 1 year ago. As a result, overall utilization rate remained flat at 55.1% as compared with the end of June. In addition, our retail MRR per cabinet ramped up to RMB9,287 in the third quarter compared with RMB9,186 in the previous quarter.

Our third quarter financial results reflect healthy progress in our wholesale and retail business as well as our effective execution of our dual-core strategy. Our net revenues for the third quarter increased by 16.3% year-over-year to RMB1.814 billion, and adjusted EBITDA reached RMB455 million.

Today's world is preparing for digital as the new norm. For businesses to adapt and thrive in this new area, digital transformation is paramount. As we witnessed the 20th National Congress of the CPC, the central government supports this transformation as part of China's high-quality growth trajectory. Policy guidelines favoring technological innovation and digital development across a wider spectrum of industries are in place. We are excited to see the digital infrastructure sector at the forefront of this broad-based digitalization effort and believe that it will further fuel market demand for data center services. As a leading player in the IDC space, we are ideally positioned to capture this burgeoning demand and unleash new growth potential going forward.

Despite a challenging and a volatile near-term macro environment, we see long-term demand remains strong with fundamental surrounding cloud and digital transformation still intact. In response to the short-term headwinds, we plan to adopt a more prudent approach to our cabinet delivery for the fourth quarter. Therefore, we are further revising our 2022 full year cabinet delivery plan to the range of 8,000 to 9,000 from a previous range of 9,400 to 12,400. The current outlook has factored in macro softness, slower move-in and the COVID-related restrictions.

Now let's take a closer look at our progress across our business lines during the third quarter. On the wholesale business front, we continued to gain sales momentum. In the third quarter, we signed a new contract of approximately 15 megawatts with a leading cloud service provider in China to build its network infrastructure in the Yangtze River Delta region. Moreover, we recently once again extended our wholesale data center services contract with one of our largest existing customers, a leading social platform in China. This new order will generate capacity of approximately 33 megawatts.

Since the launch of our wholesale business in 2019, we have established a strong presence in this market segment, accumulating total contracted capacity in service or under MoU of 283 megawatts by the end of the third quarter. Our in-depth industry know-how, methodical resource management and sophisticated engineering capabilities are key to our success in this sector.

On the retail business front, we are pleased to have delivered a growth amid a challenging macro environment highlighted by an expanding customer base and exciting progress in value-added service offerings. In the third quarter, a swath of existing customers in automobile, financial services, online gaming, local services and many other sectors extended their orders with us. At the same time, we also attracted more new customers among financial institutions, the health care service providers and local service platforms.

Furthermore, our value-added services continue to attract new prospects to our retail business. In the third quarter, we won several prestigious customers for our interconnectivity services, including a world-leading consumer electronics tech brand, a leading insurer in China and a well-known restaurant chain operator in China.

In particular, for its restaurant chain operator, we began to offer our in-house developed interconnectivity solution built on our innovative SD-WAN technology. Upon implementation, this solution will successfully provide deployment of secure, flexible and reliable connectivity across the customer's national network with more than 2,000 stores. We view this project as a milestone in the go-to-market of our state-of-art SD-WAN technology as well as a good starting point to roll out the solution into different verticals.

Turning to our Blue Cloud business. We have continued to make progress on our Cloud Landing in China business. In the third quarter, we helped a leading international IoT automation company to manage its cloud-based product offerings accessible to customers in China and are providing operation and maintaining service accordingly. This project illustrates our remarkable value proposition in helping international technology companies find a more efficient and effective way to enter and expand into the China market.

In addition, this quarter, we extended a cloud solution to an emerging Chinese smart EV enterprise by developing an integrated and efficient supply chain management system, which is seamlessly tailored to the customer's auto parts procurement process and deeply integrated with other module-based solution in its digital infrastructure. Going forward, we aim to strengthen our presence in the automotive ecosystem and explore more industry-specific cloud business opportunities across a wide variety of verticals by leveraging our unique strengths in IDC technology and cloud services.

Before I wrap up my remarks today, I'd like to take a moment to celebrate our valuable partnership with Changzhou Hi-tech Jinlong Holding Group, a subsidiary of the state-owned Changzhou Hi-tech Group, to form a joint venture with a total investment of RMB2 billion. The capital contribution from VNET will be up to RMB700 million. Drawing on both companies' resources and expertise, this new joint venture will pursue new opportunities to acquire, develop and operate IDC projects across the nation.

The JV's initial pipeline of the potential acquisition targets includes a number of high-quality data center assets located in multiple mega city clusters in China such as the Greater Beijing area and the Greater Bay Area. This partnership represents an important step towards expanding our business horizons and strengthening our presence in the digital infrastructure sector.

In summary, we see strong long-term demand and a bright future for IDC services in China despite short-term macro turbulence. With government support, our effective and flexible dual-core growth strategy and competitive service offerings, we are well equipped to navigate near-term challenges and capitalize on future demand prospects. We will continue to execute prudently yet decisively, strategically positioning the company to capture rising opportunities as more industries forge ahead with their digital transformation, creating long-term value for our shareholders along the way.

Thank you, everyone. With that, I will now turn the call over to our CFO, Tim, to discuss our financial performance for the quarter and our business outlook.

Tim Chen *VNET Group, Inc. - CFO*

Thank you very much, Jeff. Good morning, and good evening, everyone. Before we start the detailed discussion of our financials, 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 earnings press release. Please also note that, unless otherwise stated, all the financials we present today are for the third quarter of 2022 in Renminbi terms.

We're pleased to report another quarter of results which reflects the effectiveness and agility of our dual-core growth strategy in a challenging macro environment. We remain confident in our distinctive growth strategy, outstanding value proposition and a powerful suite of service offerings, which empower us to capitalize on long-term prospects of the data center industry in China.

Next, let me walk you through our third quarter financial results. Unless otherwise specified, the growth rates I will be reviewing are all on a year-over-year basis. In the third quarter, our net revenue increased by 16.3% to CNY1.81 billion from the same period last year, mainly due to increased customer demand for our highly scalable carrier- and cloud-neutral IDC solutions from both wholesale and retail IDC businesses as well as the continued growth of our cloud business and VPN service.

Gross profit was CNY316.6 million in the third quarter of 2022, representing a decrease of 15.6% from the same period of 2021. Gross margin was 17.5% in the third quarter of 2022 compared to 24% in the same period of 2021. Adjusted cash gross profit, which excludes depreciation, amortization and share-based compensation expenses, was CNY707.7 million in the third quarter of 2022, an increase of 4.9% from the same period of 2021. Adjusted cash gross margin in the third quarter of 2022 was 39.0% compared to 43.2% in the same period 2021.

Adjusted operating expenses, which exclude share-based compensation expenses and compensation for postcombination employment in an acquisition, were CNY275.1 million in the third quarter of 2022 compared to CNY244.0 million in the same period of 2021. As a percentage of net revenues, adjusted operating expenses in the third quarter of 2022 were 15.2% compared to 15.6% in the same period of 2021.

Adjusted EBITDA in the third quarter of 2022 was CNY455.3 million, representing an increase of 1.1% from the same period of 2021. Adjusted EBITDA in the third quarter of 2022 excluded share-based compensation expenses of CNY35.2 million. Adjusted EBITDA margin in the third quarter of 2022 was 25.1% as compared to 28.9% in the same period of 2021.

Our net loss attributable to ordinary shareholders in the third quarter of 2022 was CNY425.2 million compared to a net profit of CNY156.2 million in the same period of 2021. Basic and diluted loss were both CNY0.48 per ordinary share and both CNY2.88 per ADS. Each ADS represents 6 Class A ordinary shares.

Turning to our balance sheet. As of September 30, 2022, the aggregate amount of the company's cash, cash equivalents and restricted cash was CNY3.76 billion. Meanwhile, net cash generated from operating activities in the third quarter of 2022 was CNY 607.4 million compared to CNY134.7 million in the same period of 2021. Our Capex in the third quarter of 2022 was CNY 580.5 million.

Moving to our financial outlook. We are maintaining our outlook for the full year of 2022 with net revenues expected to be in the range of CNY7,250 million to CNY 7,550 million and adjusted EBITDA expected to be in the range of CNY1,800 million to CNY1,950 million.

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

QUESTIONS AND ANSWERS

Operator

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

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

Hello, can you hear me? I have one question regarding future Capex plan given the company has already decide to set up a JV with a partner. How should we think about the future Capex split or the stakes in the JV for the future expansion? Yes, I just have this question. Thank you.

Jeff Dong ***VNET Group, Inc. - President & CEO***

Okay. In terms of the CapEx plans, I'll leave the question to Tim. To address the cooperation with Changzhou, I would highlight is from my discussion, VNET will take like 35% of the equity interest in the JV structure with Changzhou, which are kind of the strategic partnership between VNET and the Changzhou Hi-tech Jinlong Holding Group, a subsidiary of state-owned group to form a joint venture. We saw as of the RMB 2 billion, I mean, given that, joining both companies' resources and expertise, this new joint venture will pursue new opportunities in the future to acquire, develop and operate certain projects across the nation.

And I mean, for VNET, the JV's initial pipeline includes a number of the high-quality assets located in the Greater Beijing area and the Greater Bay Area, especially for the Bay Area, which is, I mean, kind of a strategic exposure to us since we have less exposure there. And this partnership also represents an important breakthrough in expanding our business horizon. For example, our future fund management and also strengthening our presence in the digital infrastructure sectors.

Tim Chen ***VNET Group, Inc. - CFO***

Can you hear me?

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

Yes. I can.

Xinyuan Liu ***VNET Group, Inc. - Investor Relations Director***

Yes.

Tim Chen ***VNET Group, Inc. - CFO***

Yes. Okay. So basically, for the second part of the question, I think you were asking a little bit in terms of the Capex and impact to sort of Capex split. I think the company is looking at its overall Capex spend. Obviously, the markets are challenging at the moment on the offshore side. But I would stress that, overall, VNET continues to enjoy very, very strong support from the local onshore Renminbi banks in terms of project financing and other forms of financing available to us. But we are looking at the overall Capex. And cooperations or joint ventures like the one that Jeff just mentioned, I think, are an important way for us to continue to be able to secure the resources necessary for our customers while at the same time perhaps moderating the cash spend on our side. So it really is an attempt to find ultimately the split between kind of these types of ventures. And VNET will depend on the target projects. So Jeff's talked about some of the areas that are focused with Changzhou. And so for those types of projects, obviously, then we would have a smaller -- a share or smaller split. But the overall scale itself is also capped. So I'd say keep watch over this space. But at the moment, it is a way for us to diversify our funding sources a bit. Thank you.

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

Got it. May I follow up that? The company will not put all the new pipeline in the JV, right, just the big selective project in the JV.

Tim Chen ***VNET Group, Inc. - CFO***

That's correct. That's correct. There are targeted projects that will be put in, so not the entire pipeline, no.

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

Is there any overall strategy on who or what is the thought or what type of project will be put in the JV and what will be done by VNET itself or partner with other potential funding partner or, yes, other players?

Tim Chen ***VNET Group, Inc. - CFO***

I'll tackle this as well. So Jeff just now mentioned sort of Greater Beijing area, Greater Bay Area. So those are 2 areas that we're looking at specific projects with Changzhou on the JV. Obviously, that could expand, but there is a limited pool of capital there as well. So that's the initial focus. And there are already targeted projects that we're looking at with them. So when we have more details, it will be shortly disclosed to the market.

Operator

Our next question will come from the line of Edison Lee from Jefferies. Your line is open.

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

Hi, thank you very much for taking my questions. My first question would be very much targeting Jeff, and I want to congratulate Jeff on becoming the CEO. But Jeff, can you share with us your near-term objectives in this position and maybe also your longer-term vision for the company? And I think it's important for investors to also find out what your KPIs are? And because there's a privatization deal going on right now, so I think investors definitely would like to find out, in fact, where the company is headed? Right, under your leadership. So that's question #1.

Question #2 is about the Changzhou JV. I understand that VNET is going to manage all the projects that will be acquired by this Changzhou JV. So I want to know operationally, what are those IDCs that will be acquired by the Changzhou JV will actually be integrated with VNET? And how does that work? Thank you.

Jeff Dong ***VNET Group, Inc. - President & CEO***

Okay. Thank you. First question, I would like to say, my goal actually for the short term and try to -- I mean, there's a couple of things. The first thing is in terms of the strategy, I will continue to strengthen our wholesale and retail dual-core growth strategy. And second of all is to try to improve our operations, optimize the overall operations and diversify our customer base. We will have some new customers such as the financial institutions and some new economy like the EV sectors, et cetera. And another thing is to try to reach the -- we've done some restructure from our middle office, try to improve our efficiencies as well. And for the long term, we will do some cost control and acquire some quality EBITDA increase, et cetera, as you mentioned. And that's first to address the first question.

And regarding your second question and for the Changzhou, I think most of the people are interested in this part. And I would say Changzhou cooperation is more like we team up together to identify some certain assets, which is kind of a debt restructure on the target. So going forward, we will try to leverage the Changzhou platform and to expand our AUM and our exposures going forward, which is a key to strategically position ourselves on this respect. So that's my questions' answers.

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

Can I follow up with another question, which is, will VNET be selling your existing assets into this joint venture?

Jeff Dong ***VNET Group, Inc. - President & CEO***

I don't think so.

Tim Chen ***VNET Group, Inc. - CFO***

Edison, I'll handle that.

Tim Chen ***VNET Group, Inc. - CFO***

Yes. These are new projects, Edison. So we would not -- this is not an instrument where we would be selling our existing pipeline into this entity. So there are new projects being identified and targeted. Jeff talked about sort of debt restructuring. These are also projects where perhaps there is an opportunity given the current owners of some of these projects. And so we're teaming up with someone with the financial firepower to be able to take advantage of these opportunities.

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

I see. So let me clarify that. So it seems that the Changzhou joint venture will focus on brownfield projects. And so that's why VNET will continue to focus on greenfield projects. So would that be an accurate thinking?

Tim Chen ***VNET Group, Inc. - CFO***

The current targets, yes, would be potentially a brownfield or otherwise, yes. So less greenfield projects. But yes, we won't be selling our pipeline into that entity itself.

Operator

Our next question will come from the line of Sara Wang from UBS.

Sara Wang ***UBS Investment Bank, Research Division - China Telecom and Equipment Analyst***

Hi, thanks for the opportunity to take my questions. So I have one question. So I noticed that we have revised down the cabinet delivery plan. So what's our latest Capex budget for this year and next year? And also, as Jeff just mentioned, cost control is one of the long-term target. So just wondering if there's any time line target for VNET to achieve, say, positive free cash flow or self-financing.

Tim Chen ***VNET Group, Inc. - CFO***

Sara, can you hear me?

Xinyuan Liu ***VNET Group, Inc. - Investor Relations Director***

Yes. We can.

Sara Wang ***UBS Investment Bank, Research Division - China Telecom and Equipment Analyst***

Yes. We can.

Tim Chen ***VNET Group, Inc. - CFO***

Okay. Good. I'll take this one. So your first question was on cabinet delivery. And for that, we are, as we mentioned, revising our cabinet delivery into the range of 8,000 to 9,000. And basically, the outlook for the sort of rest of this year into next year, we've already factored in the overall macro softness that we've seen, also the slower move-in, and then there are some construction delays related to COVID-related restrictions. But those are, I would say, less of a factor, but still a factor in terms of shifting perhaps this year into next.

In terms of our outlook into 2023, we'll give some more color in fourth quarter. But we're expecting that next year's delivery will be similar to this year, perhaps a little bit better. What was your second question, Sara?

Sara Wang ***UBS Investment Bank, Research Division - China Telecom and Equipment Analyst***

So as cost control is one of the long-term target. So just wondering if there's any time line target for VNET to achieve self-financing or like positive free cash flow, yes.

Tim Chen ***VNET Group, Inc. - CFO***

So I think, overall, if you look at our financing plans right now, there's a couple of things that we're focused on. One is on the Capex side and obviously sort of cash-out. I would say that we're increasingly selective on our Capex and sort of prudent Capex spend. We do also still have very strong support from the domestic banks onshore financing and then alternative financing in terms of the Changzhou cooperation as well as exploring onshore REIT structures.

And then last but not least, when you're sort of looking at our overall ramp-up, you continue to see the billable cabinets increasing. I would say that, just given all these things put together, probably targeting 2024, I think next year still will be quite challenging just given the fact that we were still targeting something in a range of CNY 3.5 billion to CNY 4 billion of Capex. But again, some of it, we can moderate with these cooperations.

Operator

Our next question will come from the line of Ethan Zhang from Nomura.

Ethan Zhang ***Nomura Securities Co. Ltd., Research Division - Analyst***

My question is, I note that our third quarter EBITDA margin was down like 3 percentage points compared to 2Q or 3Q of last year. I just wonder, could management give us some breakdown or quantitative impact of different negative factors that affect our EBITDA margin? And what is the outlook for the EBITDA margin for next year? Thank you.

Tim Chen ***VNET Group, Inc. - CFO***

Ethan, it's Tim here. In terms of overall EBITDA margin, actually, we've the company has been working quite hard on cost controls because we have seen during the course of this year, obviously, costs like utilities and so forth going up. But we've managed to moderate that with some cost controls and also deferral of costs for third quarter.

In terms of the next year and expectations, I think that we expect that the margin compression will also then flatten out. But it will depend on the overall continued ramp-up of the business and that there will be no further changes to our underlying cost of sales. But we'll have some more details in the fourth quarter in terms of our views as we end this year. Thank you.

Operator

Our next question will come from the line of Alex Wang from Daiwa.

Alex Wang ***Daiwa Securities Co. Ltd., Research Division - Research Analyst***

Yes. Sorry, can you hear me?

Tim Chen ***VNET Group, Inc. - CFO***

Yes. Very clear.

Alex Wang ***Daiwa Securities Co. Ltd., Research Division - Research Analyst***

Okay. Yes, it's Guohan from Daiwa. So first 2 questions. So first is, could you guys share more about estimated Capex for all our existing unfinished projects within our pipeline?

And second question is, could you share more color on debt repayment issue and the pressure from potentially lingering that? Thanks.

Tim Chen ***VNET Group, Inc. - CFO***

Sure. Let me take your second question first. In terms of repayments, we have a small outstanding convertible note that's coming up next year, first half, around USD 70 million. And then our next maturity bump will be -- are 600 million in CD. So that's something that we have already started planning for and we'll be tackling during the course of 2023.

In terms of your second question, look, you're talking about Capex on our outstanding MoU projects? Or what do you mean by -- we have Capex spend this year, obviously, for projects that we're delivering in 2023. But we also then have the continued development of new projects as well. So I just wanted to clarify the question.

Alex Wang ***Daiwa Securities Co. Ltd., Research Division - Research Analyst***

Yes. Just excluding the partnership with Changzhou, yes, so what's the estimated Capex for our existing unfinished projects within our own pipeline in the next 3 years?

Tim Chen ***VNET Group, Inc. - CFO***

Probably won't be able to give you a next 3-year guidance here. We have actually more than one of these Changzhou types of projects under discussion. So what I can tell you is that what we're looking at for next year is probably a similar Capex as this year. And it includes the remaining deliveries for this year, for deliveries in '23 and obviously, preparations next year for deliveries of '24 in terms of the power infrastructure and so forth.

We'll probably come to you off-line and have some discussion on the general parameters for the coming 3 years. But obviously, as we continue to get new MoUs each quarter, that number will change and shift. And so we'll have to rerun those numbers as well because we've just had a couple of new MoU wins. Thank you.

Operator

That's all the time we have for Q&A today. Ladies and gentlemen, that concludes our conference for today. Thank you for participating. You may now disconnect. Everyone, have a great day.
