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Q2 2019 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 Second Quarter 2019 Earnings Conference Call. (Operator Instructions) 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 will now like to turn the call over to the first speaker today, Ms. Rene Jiang, IR Director of 21Vianet. Please go ahead, ma'am.

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

Hello, everyone. Welcome to our second quarter 2019 earnings call. Before we start, please note that this call may contain forward-looking statements made pursuant to the safe harbor provisions of 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 statement, risk factors and details of the company's filing 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 for our earnings call today. During the second quarter 2019, our revenues increased to RMB 888 million and adjusted EBITDA increased to RMB 260.7 million. Both within our previously announced guidance range. Adjusted EBITDA margin expanded to 29.4% during the quarter from 26.7% in the prior year period. Hosting MRR per cabinet increased by 4.7% year-over-year in the second quarter of 2019 while decreasing sequentially due to the previously announced discontinuation of a major client's contract in early 2019.

Despite the macroeconomic uncertainties, we achieved meaningful progress during the quarter on 3 fronts: capitalizing on the growing demand for IDC solutions; upselling additional capacity to existing clients while adding new clients; expanding our capacity pipeline.

First through constant client dialogues and market monitoring, we discovered that the demand for IDC solutions is growing rapidly. On the one hand, large corporations are accelerating their business expansion to solidify their market leadership, thus elevating their demand for large-scale IDC solutions. On the other hand, small- and medium-sized companies are adapting to rapid market changes, thus requiring scalable and flexible IDC solutions. Our tailored IDC solutions are well suited for such market demand.

On the new client front, we have added several notable clients that are both large scale and long tail, including a leading manufacturer of mobile devices and an auto finance company of a top global OEM. Both have signed long-term contracts that will take effect in the third quarter of 2019. They will help to accelerate our recovery from the impact of previous customer churn on our cabinet utilization. Furthermore, we expect that this customer's demands for cabinet capacity will improve our utilization rates significantly in the second half of 2019.

On the wholesale front, we signed a memorandum of understanding in August with a major public cloud service provider in China to provide a number of cabinets. According to the MOU, all cabinets will be delivered by April 2020.

Secondly, on the client relationship front we have been actively upselling additional capacity to existing clients. During the quarter, we expanded our service contracts and [sold] (corrected by company after the call) additional capacity for Qunar, Mtime, 51VR and SpeedyCloud. All those customers have found that our carrier neutrality and service reliability are highly desirable. Consequently as they expand their business volume, they require us to grow in tandem with them.

Thirdly, we continue to make strides in expanding our cabinet capacity to meet the increasing market demand. For example, following our successful expansion into Chengdu at end of 2018, we completed the inspection of 500 retail cabinets in the city and brought them into our sales pipeline. Going forward, we also plan to add 1,000 cabinets to our sales pipeline during the third quarter of 2019 through our acquisition in the south of Beijing made in the previous quarter. We expect to complete four projects currently under construction by the fourth quarter of 2019.

To further increase our cabinets capacity and bolster our sales pipeline, we continue to [develop] our long-term hyper-scale data center in Jiangsu province during the second quarter. The Jiangsu campus boasts an estimated space of around 80,000 square meters and have the capacity to host over 8,000 high-powered density cabinets. We plan to install cabinets at this campus in phases. By the end of 2020, our first batch of cabinets at this campus should be ready for customer orders.

Furthermore, we are restructuring our partnership with Warburg Pincus to enhance our pipeline capacity. As part of this restructuring, we'll not only receive cash payment but also ownership of a project under development in the Shanghai Waigaoqiao Free Trade Zone. We will use this project to increase our cabinets capacity, which will further augment our leadership in Shanghai and its satellite areas. This new location will have capacity to host 6,000 cabinets. The first phase of its construction is expected to include over 2,000 cabinets and to be completed by early 2020.

Going forward, we will continue to cautiously assess and prudently invest in our capacity expansion initiatives. Throughout the second half of 2019, our steadfast commitment to client relationship, flexible offerings and capacity expansion to further solidify our industry leadership, we are confident of our ability to capture the current market opportunities.

Now I would like to turn the call over to Sharon Liu, CFO of our company, to give you more details on our financial results.

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 all of the financial numbers we are presenting today are in RMB terms and that percentage changes are on a year-over-year basis unless otherwise stated.

During the second quarter, we ramped up our cabinet delivery capacity to satisfy an increased number of client orders and continued to grow our sales pipeline through strategic resource planning and prudent capital management. Our success in these areas and growing market demand have contributed to our strong balance sheet as well as year-over-year growth in our revenues and adjusted EBITDA.

For the second quarter, our revenue increased by 7.2% year-over-year to CNY 888 million. Revenues benefits from client demand for scalable quality IDC services. Our hosting MRR per cabinet was CNY 8,663 in the second quarter of 2019, remained stable compared with the first quarter of 2019.

Adjusted cash gross profit, which excludes depreciation, amortization and share-based compensation expenses, increased by 10.9% to CNY 403.8 million from CNY 364 million in the same period of 2018. For the second quarter, we continue to add high-margin self-built cabinets to our sales mix and thus achieved greater economies of scale causing our adjusted cash gross margin to expand by 1.6 percentage points to 45.5% from 43.9% in the same period of 2018.

Adjusted operating expenses, which exclude share-based compensation expenses and changes in the fair value of contingent purchase consideration payable, decreased to [CNY 161.3 million] (corrected by company after the call) from CNY 161.9 million in the same period of 2018. As a percentage of net revenues, adjusted operating expenses decreased to 18.2% from 19.5% in the same period of 2018 which showed the company's continuous efforts to realize operating leverage.

Adjusted EBITDA grew by 17.9% year-over-year to CNY 260.7 million, staying within the guidance range we provided in the previous quarter. Adjusted EBITDA margin increased by 2.7 percentage points to 29.4% from 26.7% in the same period of 2019.

Net loss attributable to ordinary shares was CNY 102.1 million. Basic and diluted loss were CNY 0.15 per ordinary share and CNY 0.90 per ADS, each ADS represents 6 ordinary shares.

Moving on to our balance sheet and the liquidity. At the end of the second quarter, our debt-to-asset ratio was 59% and our debt to adjusted EBITDA ratio was 3.2. We generated a positive net operating cash flow to CNY 127.1 million during the second quarter. As of June 30, 2019, we maintained a sizable cash position of CNY 3.25 billion. The sufficient cash will cover our expansion plans.

Going forward, our healthy liquidity and operating leverage will provide a solid foundation for us to seize growth opportunities and attract more clients in a broader range of locations in China. Furthermore, our financial leverage will enable us to continue expanding our nationwide capacity in a disciplined manner and bolstering our ability to secure low-cost funding.

Due to the growing market demand and our expanding cabinet capacity, we are raising our 2019 CapEx plans to a range of CNY 1.4 billion to CNY 1.6 billion with the additional CNY 600 million investment for IDC capacity expansion beyond 2019 including investment for the wholesale project and the Shanghai Waigaoqiao project.

Turning to our guidance, we expect net revenue for the third quarter of 2019 to be in the range of CNY 950 million to CNY 980 million, and adjusted EBITDA to be in the range of CNY 250 million to CNY 270 million. For the full year of 2019, we maintain our previous guidance for the net revenue to be in the range of CNY 3.76 billion to CNY 3.86 billion and adjusted EBITDA to be in the range of CNY 1 billion to CNY 1.1 billion.

This forecast reflects our current and preliminary views on the market and operational conditions, which are subject to change. This concludes our prepared remarks for today. Operator, we are now ready to take questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) First question comes from the line of Yang Liu from Morgan Stanley.

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

I have 3 questions here. First congratulations on the first wholesale deal. Could management elaborate more about the size of the wholesale deal and the location, economics, et cetera, whether it is on the JV with Warburg Pincus or fully under 21Vianet (inaudible) The second question is that in terms of the wholesale progress, what is the future outlook here? whether management expect to sign more contracts in the following quarters this year or next year?

And the third one is outlook for the selling activity for the retail data centers, especially the early look of the new pipeline that VNET plans to release in fourth quarter this year. And also current utilization rate is not particularly high. I would like to hear your view on the starting activity of the retail data centers.

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

Hi, this is Alvin here. Thank you for the questions from Liu Yang. Actually it's -- first of all -- the first question regarding the wholesale products, we do receive for a nonbinding memorandum of understanding from 1 leading public cloud provider. Actually the list of products is not very big, actually it's a few hundred cabinets. So we have -- both sides agree this project will be the beginning of the long-term strategic cooperation. And this project will be -- basically the term will be around 8 years, and it will renew annually of after or we can negotiate.

And this project is in the area close to Shanghai, and the whole project is fully owned by 21Vianet. And also looking forward, we have as we mentioned before, we do have very strong customer engagements with leading customers from top public cloud service providers and also leading Internet players and also some other financial institutes. So looking forward, so we have very strong confidence we can secure at least another wholesale project in the coming 1 or 2 quarters. And of course, we are very optimistic, in the coming years to come we can establish our position in the wholesale segment.

And the third part -- the third question regarding the utilization rates and the retail pipeline. And we do have a pressure from the customer churn in the first quarter and second quarter. And as we mentioned before, we already signed a medium to large size contract with a few leading customers. So our utilization rates will recover in the second half of this year and so we expect that in the second half we can ramp up another -- around 2,000 cabinets added into our utilized capacity.

And also regarding our under-construction projects, we have a strong confidence we can deliver the capacity by the end of this year. And also we already received very strong pre-commitments or very strong sales pipeline coverage from our leading customers, Internet players and also financial institutes as well. Thank you.

Operator

Next question comes from the line of Rex Wu from Jefferies.

Rex Wu ***Jefferies LLC, Research Division - Equity Analyst***

So I have 2 questions now. So first is can you elaborate more about the partnership with the JV partner Warburg? What's the cost for buying back Waigaoqiao data center and what is planned for, is this plan for wholesale or retail? And my second question is regarding to the retail business, just housekeeping, so whether have you seen any potential customer churn -- have similar reason as your churn in Q1 and Q2 in the next couple of quarters.

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

Okay. Thank you, Rex, this is Sharon. I will answer your first question about our partnership with Warburg Pincus. Based on our agreement, the joint venture 2 will distribute its asset and projects to 21Vianet and Warburg Pincus on a pro rata basis which we own 49% of equity share. So the total cost will be in the range of CNY 400 million to CNY 500 million. But the final price will depend on the auditor's report. So currently, we have not the exact amount. And for the Shanghai Waigaoqiao project, it will deliver at least 6,000 cabinets for the wholesale customers and the tailored retail customers. And currently, we have attracted the potential customers from the Internet and the finance verticals. Thank you.

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

Regarding the retail business. Currently we have very strong customer demand from retail customers, especially in the -- from the top leading Internet players. And also looking forward, we haven't -- we have no -- we haven't seen any big risk to have a big customer churn in the coming quarters. Thank you.

Operator

(Operator Instructions) Follow-up questions from Rex Wu from Jefferies.

Rex Wu ***Jefferies LLC, Research Division - Equity Analyst***

Just a follow-up question on the Q2 result. So we saw the adjusted cash profit actually increase 10.9% year-over-year. I think that's one of the major driver for improving adjusted EBITDA margin. So like, can you elaborate a little more about the improvement on the cash gross margin? And can you -- do you have any guidance for the EBITDA margin long term, like when they will break 30%? I think since your organization is going to improve in the next 2 quarters I think it's very likely it will go over 30%, I assume.

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

Thank you, Rex. Our cash gross margin increase was mainly due to our mixture shift from the partner data center to the self-built data center, that is the main driver of our cash gross margin. And for the second half of this year, especially for Q4 as we will deliver additional 600 cabinets -- 6,000 cabinets to the market and the related costs and expenses we'll recognize in our income statement, so Q4, our EBITDA margin will be lower. Thank you.

Rex Wu ***Jefferies LLC, Research Division - Equity Analyst***

Sorry, can I just follow up? So like where do you see the demand in 2020 for the new retail cabinets? Like is that like mainly driven by few customers -- just a number of customers or it's very diversified?

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

Hi, this is Alvin here. Thank you for your question regarding the customer demand. If we look at the market dynamic, we do see very strong kind of a trend that the leading players, especially in the Internet domain, will take even bigger market share so which means that from our customer mix that we see the major demand for our cabinet capacity were from fewer customers than before. But still that's one of the key strengths of 21Vianet is that we have very strong retail customer base and we have very strong coverage.

So going forward, we will pursue both smaller and high-growth retail customers and also leading customers, not only the public cloud players but also the big Internet players, very strong Internet-- sorry, very strong state-owned enterprises and, of course, financial sector, et cetera. Thank you.

Operator

(Operator Instructions) We have a question from the line of Stella Li from Citi.

Stella Li ***Citi Bank - Credit Analyst***

I just want to clarify, firstly, how much cabinets do we expect to deliver in the second half of this year and then how much for next year? Can you clarify the numbers again? And also you mentioned that we expect to raise our CapEx guidance to CNY 1.4 billion to CNY 1.5 billion this year. I want to know for this additional CNY 600 million, and you mentioned for the capacity beyond 2019, is this originally expected for our 2-year guidance? Or this is new cabinets and new CapEx in addition to our guidance give out previously.

And then another question is I see the financial outlook for the third quarter. We expect our revenue to go up to CNY 950 million to CNY 980 million. However, the EBITDA margin is in the range still similar to second quarter. So I want to know what are the reasons for the lower EBITDA margin for third quarter outlook.

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

Thank you, Stella. This is Alvin. Thank you for your questions. I will take the first one regarding the capacity expansion. So as we disclosed before this year that we aim to increase our capacity by 6,000 to 8,000 cabinets. And we already delivered 500 in the first half this year and also that we have a firm plan to deliver another 1,000 in Q3 -- by the end of Q3 this year, and which means that we have another 4,000 -- 4,500 to 8,000 around cabinets to deliver by the end of this year. And going forward, the next year that's currently that we aim to deliver 15,000 cabinets. And I'd like to turn to Sharon to answer your second and third questions.

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

Hi, Stella. This is Sharon. Regarding your questions on the CapEx guidance, we reached another RMB 600 million for our other projects. This is the new additional CapEx for the projects, which includes the Shanghai Waigaoqiao, which will deliver the first phase by early next year and also the CapEx for the wholesale projects. And your third question is about our EBITDA margin. As in Q3, our utility costs will increase due to the high temperature, so we provide an EBITDA guidance just in the same range of the Q2. Thank you.

Operator

(Operator Instructions) Follow-up questions from Stella Li from Citi.

Stella Li ***Citi Bank - Credit Analyst***

Just want to clarify, you mean the higher utility costs in 3Q expected, does this make it incurred that every summer or every 2Q or 3Q that we are expecting to see this? And then usually what's the impact on the financials? And also another question, the hosting MRR for the second quarter, if we compare to the first quarter, it's actually slightly lower. Is there any expectation for this trend for 3Q and 4Q for this hosting MRR?

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

Thank you, Stella. The utility cost was always high during summer time obviously from June to September, that's why our EBITDA guidance is more conservative. And for the MRR, company believes that the MRR will be stable in the second half of this year. And we expect our MRR per cabinet to remain at 8,700 level in the second half of this year.

Operator

We have no more questions from the line. I would like to hand the call back to the management for closing remarks.

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

Thank you for joining our call. If you have any further questions, please feel free to contact IR. We look forward to speaking with everyone next quarter.

Operator

Thank you, ladies and gentlemen, that does conclude the conference for today. Thank you for your participation. You may now disconnect your lines.