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Q4 2022 VNET Group Inc Earnings Call

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PRESENTATION

Operator

Hello, ladies and gentlemen. Thank you for standing by for the Fourth Quarter and Full Year 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 Ms. Xinyuan Liu, Investor Relations Director of the Company. Please note that today's conference is being recorded.

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

Xinyuan Liu VNET Group, Inc. - Director of IR

Thank you, operator. Hello, everyone, and welcome to our fourth quarter and full year 2022 earnings conference call. Our earnings release was distributed earlier today and you can find a copy on our IR website as well as on 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 obligations 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. - CEO

Thank you, Xinyuan. Good morning, and good evening, everyone. Thank you for joining our fourth quarter and full year 2022 earnings conference call.

Laden with macroeconomic headwinds and COVID-related disruptions, 2022 was an extraordinary year. Amid this challenging environment, we delivered solid financial and operational results through excellent execution of our dual-core strategy. We achieved our 2022 delivery target by adding approximately 8,400 self-built cabinets. By the end of the fourth quarter, our total cabinets under management had grown to approximately 87,320 from 78,540 a year ago. Meanwhile, cabinets utilized by customers increased sequentially by approximately 2,500 to approximately 48,000 compared to approximately 41,700 one year ago. Our overall utilization rate was 55%. In addition, our retail MRR per cabinet increased to RMB 9,371 in the fourth quarter, up from RMB 9,287 in the third quarter.

We concluded 2022 with resilient fourth quarter revenue of RMB 1,881 million, an increase of 7.7% year-over-year and adjusted EBITDA of RMB 424 million. For the full year, our revenue grew 14.1% to RMB 7,065 million and adjusted EBITDA increased 6.8% to RMB 1,873 million.

Before we get deeper into our business details for the fourth quarter, I'd like to touch on broader macroclimate in China for some context. According to 2023 Government Work Report issued early this month, the central government set a GDP growth target of around 5% for this year, up from last year's 3%. In addition, the government will continue to accelerate the digital transformation of traditional industries and small- and medium-sized enterprises while also supporting the development of the platform economy. Last month, the central government rolled out a plan to build a Digital China by 2025, which highlighted the country's focus on expanding data resources and improving digital infrastructure.

Encouraged by these supportive measures and positive signals, we expect industry vitality to gradually recover and business confidence to rebound. In particular, we believe the Internet giants will play to their strengths in technology to empower development of the digital economy and unleashing greater demand across the markets. As China's leading IDC service provider, we are well positioned to capture new growth opportunities ahead.

Now let's take a closer look at our Q4 business updates. Execution of our dual-core strategy continues to prove strongly effective both in the wholesale and retail IDC markets. On wholesale front, we continued to gain robust sales momentum with two major orders despite the macro challenges. In the fourth quarter, we extended our wholesale data center service contract with one of our largest existing customers, a leading social platform in China. This extended order will generate capacity of approximately 33 megawatts. More encouragingly, we recently won the bid to deploy IDC services in multiple phases to support the business expansion for a new customer, one of China's Internet giants. During the first phase, we expect to provide customer with capacity of over 100 megawatts through our IDC assets located in the Yangtze River Delta region. This collaboration represents a significant development opportunity for us, adding to our proven track record of providing IDC services to powerhouse companies across China's Internet industry.

Moving on to our retail business. We continued to make meaningful progress on our customer base expansion in the fourth quarter. Supported by our premium colocation and interconnectivity offerings, as well as our value-added services, we continued to extend our services to existing customers and attract new customers, meeting increasing demands from a wide spectrum of industries, including financial services, local services, mobility, online gaming and some traditional industries. In particular, our connectivity services have tapped into a variety of sectors, including public transportation, public cloud and healthcare, another testament to our industry-leading service capabilities.

Next, I would like to highlight our progress on hybrid cloud offerings. In the fourth quarter, we successfully facilitated the digital transformation for the Mainland China operations of Watsons, a leading Asian health and beauty retailer. We provided the customer with a one-stop infrastructure as a service or IaaS solution as well as complete operations and maintenance services for both software and hardware to optimize customer's IT architecture, enhance its business reliability and improve operational efficiency. Looking ahead, we will continue to empower our customers' transitions into the evolving digital era by leveraging our IDC asset, network and service capabilities.

Turning to our ESG initiatives. We have always held our long-term commitments and responsibilities to our industry, environment and society as the foundation of our ongoing success. Our dedication and hard work are paying off, earning the Company broad recognition from globally-renowned ESG ratings agencies. We made great progress in our ESG ratings in 2022, thanks to our continuous efforts in improving our ESG performance. MSCI upgraded us to "A" rating in December 2022, which represents the highest ranking to date in China's Internet Service and Infrastructure industry. In addition, our ESG score measured by the S&P Corporate Sustainability Assessment reached 57, ranking the top 10% among all companies in the IT Services industry globally.

We also submitted CDP's climate change questionnaire in 2022 and achieved a "B" grade, which exceeded that of 96% of participating companies in China. These accomplishments and accolades clearly demonstrate the effectiveness of our ESG strategy, while strongly affirming our long-term investment value and development prospects.

Moving into 2023, while the economic recovery is still underway and may need time to realize a full rebound, we remain confident in the long-term growth potential of China's market as well as the IDC service industry as a whole. As a result, we set our 2023 delivery plan in the range of 8,000 to 9,000 cabinets. We believe supportive government policies will accelerate China's digitalization across multiple

industries and our proven dual-core growth strategy and industry-leading service capabilities will keep us at helm of the market recovery. We'll remain agile as we navigate shifting market dynamics and capitalize our future growth opportunities, creating sustainable and long-term value for our shareholders. Thank you, everyone.

I will now turn the call to our CFO, Tim, to discuss our financial performance for the quarter and our business outlook.

Tim Chen VNET Group, Inc. - CFO

Thank you, Jeff. Good morning, and good evening, everyone. Before we start the detailed discussions of our financials, please note that we will present non-GAAP measures today. Our non-GAAP results exclude certain non-cash 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 fourth quarter of 2022 and in Renminbi terms.

As Jeff just mentioned, we concluded 2022 with resilient operating and financial performance, amid myriad of external challenges, which speaks to our outstanding execution.

Next, let me walk you through our fourth quarter financial results. Unless otherwise specified, the growth rates I will be reviewing are all on a year-over-year basis.

In the fourth quarter, our net revenue increased by 7.7% to RMB 1.88 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 and VPN services.

Gross profit was RMB 328.4 million in the fourth quarter of 2022, representing a decrease of 13.6% from the same period of 2021. Gross margin was 17.5% in the fourth quarter of 2022, compared to 21.8% in the same period of 2021.

Adjusted cash gross profit, which excludes depreciation, amortization and share-based compensation expenses was RMB 740.1 million in the fourth quarter of 2022, an increase of 3.7% from the same period of 2021. Adjusted cash gross margin in the fourth quarter of 2022 was 39.4%, compared to 40.9% in the same period of 2021.

Adjusted operating expenses, which exclude share-based compensation expenses, compensation for postcombination employment in an acquisition, impairment of loan receivable to potential investee and impairment of long-lived assets, were RMB 355.4 million in the fourth quarter of 2022, compared to RMB 273.7 million in the same period of 2021. As a percentage of net revenues, adjusted operating expenses in the fourth quarter of 2022 were 18.9%, compared to 15.7% in the same period of 2021.

Adjusted EBITDA in the fourth quarter of 2022 was RMB 424.3 million, representing a decrease of 8.3% from the same period of 2021. Adjusted EBITDA in the fourth quarter of 2022 excluded a reversal of share-based compensation expenses of RMB 7.8 million. Adjusted EBITDA margin in the fourth quarter of 2022 was 22.6%, compared to 26.5% in the same period of 2021.

Our net loss attributable to ordinary shareholders in the fourth quarter of 2022 was RMB 64.2 million, compared to a net loss of RMB 27.3 million in the same period of 2021.

Basic and diluted loss were both RMB 0.07 per ordinary share and both RMB 0.42 per ADS. Each ADS represents six Class A ordinary shares.

Now turning to our balance sheet. As of December 31, 2022, the aggregate amount of the Company's cash, cash equivalents and restricted cash was RMB 2.99 billion. Meanwhile, net cash generated from operating activities in the fourth quarter of 2022 was RMB 569.6 million, compared to RMB 664 million in the same period of 2021.

Our CapEx in the fourth quarter of 2022 was RMB 1.21 billion, and the total CapEx for the full year 2022 was RMB 3.35 billion.

Now moving to our outlook. We expect net revenues for the full year of 2023 to be in the range of RMB 7,600 million to RMB 7,900 million, representing a year-over-year increase of 7.6% to 11.8%, and adjusted EBITDA to be in the range of RMB 2,025 million to RMB 2,125 million, representing a year-over-year increase of 8.1% to 13.5%.

Looking forward, we will continue to execute on our dual-core growth strategy and remain focused on our core business as well as higher quality revenues. In addition, we will continue to explore more capital resources to further strengthen our financial position.

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 comes from the line of Yang Liu of Morgan Stanley.

Yang Liu *Morgan Stanley, Research Division - Equity Analyst*

Two questions from my side. The first one is about the move-in. Could management share the color year-to-date what is move-in looks like from your retail and wholesale customer? And what should be the utilization rate by the end of this year, if we add another 8,000 to 9,000 cabinets. Yes, that's the first question.

And the second question is, we are glad to see that the Company onboard a new wholesale customer with a pretty big order size. When should we expect the financial contribution will be visible in future?

Jeff Dong *VNET Group, Inc. - CEO*

Yang, can you hear me?

Yang Liu *Morgan Stanley, Research Division - Equity Analyst*

Yes, I can.

Tim Chen *VNET Group, Inc. - CFO*

Okay. Let me take the second question, and then I'll pass it back to Jeff and the team on the first question on the ramp-ups. For the new customer that we've announced just now, we're expecting the financial contribution to take place basically end of this year, early next year. So obviously, it's going to take us time to deliver the cabinets. So by the time, meaningful financial contribution takes place at the end of 2024. I hope that's helpful.

Let me pass the ramp-up in terms of what we've been seeing in fourth quarter and the first few months of the first quarter, to Jeff and team.

Jeff Dong *VNET Group, Inc. - CEO*

Yang, it's Jeff. Regarding the ramp-up at the end of 2022, we will be 55% utilization rate. We expect more for this year. Let me give you some colors on the new customers, just Tim mentioned. It certainly is actually the large majority of the available cabinets in Q4. So we can see, as you mentioned, the move-in from Internet players is very good and faster than what we expect from the cloud service providers. Given the contribution to our financials, I would say in terms of this contract, we'll see by the end of this year, it's about over 70 megawatts to be delivered by the end of this year. So we see substantially and logical financial contributions will come up next year and afterwards.

Operator

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

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

So I have 1 question. So would management please walk us through the financing plan and also the major cash inflows and outflows for this year, especially given 1 of the convertible bond might be puttable for early next year.

Tim Chen VNET Group, Inc. - CFO

Thanks, Sara, for the question. It's Tim here. With regards to the overall financing plan, we've obviously started already at the end of last year going through the alternatives available to the Company. We've seen with quite positive news that the public markets are gradually opening up. As to the major sort of inflows and outflows, obviously, the business continues to generate a very healthy operating cash flow.

Outflows would be mainly the CapEx, and at this moment, we're expecting CapEx to be quite similar to what it was in 2022, which is between RMB 3 billion to RMB 3.5 billion. However, I would then point out next is that this CapEx is not all committed or contracted. So we do have the ability to ratchet back during the course of the year, and we'll do so really for 2 areas.

One is, as we see the customer demand and also the customer requirements in terms of delivery dates, if they shift, you've seen us also in 2022, adjust during the course of the year as required. And then secondly, obviously is, we are planning our overall cash flow for the potential refinancing of the convertible bond that would be in first quarter of 2024.

So that's something that we're keeping a very close eye on and obviously looking to the various alternatives. Obviously, given where share prices are for us and our peers, we will be looking mainly at debt and convertible as the main instruments. Also something that we already mentioned last year, we continue to work on, would be onshore Renminbi financing both in the form of private and public reach. I hope that answers your question, Sara.

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

And just a quick follow-up. On the operating cash flow for 2022, it seems it was RMB 2.6 billion. So how shall we think about the operating cash flow level for 2023?

Tim Chen VNET Group, Inc. - CFO

Yes. I would say that, look, the working capital point will not move very, very much. So you're looking at underlying EBITDA as a good proxy. So obviously, we've given some guidance on EBITDA. I think you use that as a proxy on where directionally we expect operating cash flow to go as well.

Operator

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

Edison Lee Jefferies LLC, Research Division - Equity Analyst

I have 2 questions. Number one is, on this new customer that you have signed up for over 100 megawatts, so based on your comment a little bit earlier, I assume that the 3,000 cabinets that you're including in your 2023 guidance is not related to this customer. I just want to confirm that. And also, could you give us some color on the pricing and also on the potential for follow-on orders for this particular customer in the same region or in the same data center campus.

And my number two question is, is it possible for you guys could give us an update on your joint venture IDC fund with the Changzhou SOE. And in fact, is that being factored into your 2023 guidance? Or how much of that is being impacted into that?

Jeff Dong VNET Group, Inc. - CEO

Let me answer your questions. The first one, in terms of new customers. Yes, it is. We included 3,000 cabinets this year, which is from the first phase of the new customer.

Edison Lee Jefferies LLC, Research Division - Equity Analyst

Sorry, yes. So can I confirm that this 3,000 cabinets will be delivered towards the end of the year, so that's why the financial contribution in 2022 is what the....

Tim Chen VNET Group, Inc. - CFO

Yes. That's correct. It's Tim here. That's correct. We're expecting that these will be delivered at the very tail end of the year. And so I don't expect, at least from my side, any meaningful financial contribution probably a little bit at the very beginning of it. But really, the meaningful contribution will be in 2024, first quarter.

Edison Lee Jefferies LLC, Research Division - Equity Analyst

Sorry. Can I also follow up with just one related question. So will this 100 megawatts be fully delivered within 2024? Or it's going to go into 2025?

Jeff Dong VNET Group, Inc. - CEO

It's going to be divided into different phases. Under the first phase, it will be this year, we will deliver like 2/3 and the remaining will be delivered in the next year.

Edison Lee Jefferies LLC, Research Division - Equity Analyst

So it will be completely delivered in 2024?

Tim Chen VNET Group, Inc. - CFO

No, sorry. The first phase, the first part is going to be mainly in the 2023. But the balance, we will need to see whether the customer will give us the heads up. So it depends on their move-in rate. If the move-in rate is very, very strong, they may give us an earlier go-ahead, in which case, yes, it would be in 2024. But if not, it could actually drag into the outer years.

Edison Lee Jefferies LLC, Research Division - Equity Analyst

I'm sorry, I want to further clarify because I think that's an important point. So this 100-megawatt contract, you already signed the MOU with the customer. However, the timing of delivery is actually not specified in the MOU. Is this understanding correct?

Tim Chen VNET Group, Inc. - CFO

Only part of it is specified and the balance is not. The indications that they've given us -- yes, yes, correct.

Jeff Dong VNET Group, Inc. - CEO

Tim, let me put this way. We will be fully delivered within the 3 years per the MOU with the customer.

Edison Lee Jefferies LLC, Research Division - Equity Analyst

And in the same location, right? All these capacity is at the same location.

Jeff Dong VNET Group, Inc. - CEO

Yes, same location. Yes. In terms of the second question...

Edison Lee Jefferies LLC, Research Division - Equity Analyst

Sorry, Jeff, please go ahead.

Jeff Dong VNET Group, Inc. - CEO

Okay. Let me answer your questions in terms of the JV with Changzhou, recently we signed a SPA in Langfang area with one project, which is the largest one from the identified portfolio. The JV has already committed over RMB 500 million, and as a proportion, we also committed the capital. And this Langfang project will achieve IT scale of about 140 megawatts and also will be delivered more than 17,000 cabinets, in total. So that's what we have done so far. And some other projects, we are also closely in discussion with Changzhou and will be ramping up soon, probably by the end of this year, including Shenzhen, Dongguan and also in Central Beijing areas.

Edison Lee Jefferies LLC, Research Division - Equity Analyst

Just a follow-up. So will this Langfang project be contributing profitability to VNET this year?

Jeff Dong VNET Group, Inc. - CEO

I wouldn't see it contribute to VNET's financials, but it's also divided into the different phases. The Phase I and Phase II has already had customers, and we are signing the SPA on the Phase III and Phase IV, which is a greenfield project with a full regulatory license, hopefully will be delivered by the end of this year and ramping maybe next year.

Operator

Ladies and gentlemen, that concludes our conference today. Thank you for participating. You may now disconnect.

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