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Q3 2023 VNET Group Inc Earnings Call

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Timothy Zhao *Goldman Sachs Group, Inc., Research Division - Research Analyst*
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PRESENTATION

Operator

Hello, ladies and gentlemen. Thank you for standing by for the Third Quarter 2023 Earnings Conference Call for VNET Group, Inc. (Operator Instructions) Participants from our management include Mr. Jeff Dong, Chief Executive Officer; Mr. Qiyu Wang, Chief Financial Officer; Mr. Tim Chen, Chief Strategy Officer; and Ms. Xinyuan Liu, Investor Relations Director of the Company. Please note that today's conference call is being recorded.

I'd now like to turn the call over to the 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 third quarter 2023 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 today's call 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 and 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 call today. I'd like to start with the overview of our third quarter performance. Our solid growth in the third quarter reflects our continued focus on high-quality business opportunities. Cabinet deliveries are progressing smoothly, and by the end of the quarter, we had grown our total cabinets under management to approximately 88,900 compared with approximately 82,660 one year ago. The number of utilized cabinets increased by 1,092 to 52,408 in the third quarter, driving our overall utilization rate to 59%. Furthermore, our retail MRR per cabinet during the quarter stayed high at RMB 9,495. We remained dedicated to adding high-quality revenue in both the wholesale and retail IDC markets in the third quarter, generating solid year-over-year growth with our total net revenues increasing by 4.0% to RMB 1.89 billion and adjusted EBITDA growing by 11.6% to RMB 507.9 million.

With the rapid pace of large language model training and AI application deployments, computing power is becoming a new productive force. To meet the growing need for computing power, China's governing authorities have recently unveiled an action plan for the high-quality development of computing power infrastructure nationwide. As the industry's leading player, we are seeing increasing demand for premium IDC services and we remain a clear choice for customers to ride the wave of digital transformation.

Now let's take a closer look at our third quarter business updates. First, AI is driving increasing demand for computing power and IDC services. Our wholesale data centers continued to meet the increasing AI demand driven by our customers' rapidly growing business. Equipped with high power density capabilities we excel in powering large language model training and deployments for internet platforms.

Our core competencies spanning resources and execution capabilities enable us to support our customers' evolving and sustained business development needs. As we mentioned on our last call, in August we won an extended order of 45 megawatts from an existing internet giant customer, which speaks to our superior wholesale service offerings' appeal amid the competitive landscape.

Moreover, our cabinet deployment execution has been stellar. During the third quarter, we successfully delivered over 2,600 high power density cabinets in the Yangtze River Delta region to one wholesale customer and approximately 800 high power density cabinets in the northern region of China to another wholesale customer. Throughout the delivery process, we maintained strict quality standards while offering customization options tailored to customer requirements. This execution is a testament to our commitment to timely delivery and top-notch quality, which has earned us a reputation for reliability and customer satisfaction.

Our retail customers' AI-driven demand continued to rise, particularly from existing customers in industries such as local services, healthcare and VR. Building on this momentum, we expect to attract more retail customers from a wider range of industries such as autonomous driving and AI solutions. I'd also like to highlight our distinctive proficiency in designing and implementing power and equipment upgrades for our cabinets to meet existing customers' high power density computing needs. This capability is well supported by our engineering experience and expertise as well as our existing high-power density cabinets, which allow us to promptly address growing diverse AI demands from retail customers. In addition, we further expanded and diversified our retail customer base in the third quarter, attracting new customers and securing extended contracts from existing customers in various industries, including IoT, financial services, gaming and mobility. It's also worth noting that we recently won a new order of 1.5 megawatts from an existing customer, a world-leading consumer electronics tech brand.

Now turning to our value-added services. During the third quarter, our full-stack, one-stop Bare-Metal-As-a-Service solution continued to gain new customers, one of which is a pioneering unicorn in the VR industry. We won the contract based on our flexible computing power resources that can readily meet this customer's specific demands during peak business hours, underpinning the rapid growth of its metaverse business.

Our diverse IDC service offerings include a solid IT infrastructure, premium operations and maintenance services, and impressive cost-efficient solutions, making VNET an outstanding choice for potential customers looking for a trusted partner to support their current and future business development needs.

We have also attracted a leading Chinese EV automaker for our interconnectivity services. Throughout our robust data center and network resources nationwidethe customer can store their business data in adjacent data centers and transmit with low-latency backhaul. This customer win reaffirms our compelling value proposition and advanced interconnectivity service capabilities.

In summary, our robust third quarter results showcase our ability to effectively address both wholesale and retail businesses' IDC needs, backed by timely and strong execution. Looking ahead, AI prevalence and adoption is emerging across industries and supportive government policies will accelerate the development of computing power infrastructure in China. As a dedicated industry leader, we look forward to meeting this newest wave of demand driven by AI applications and further unleashing our long-term growth potential.

Thank you, everyone. I will now turn the call to Qiyu to discuss our financial performance for this quarter.

Qiyu Wang ***VNET Group, Inc. - CFO***

Thank you, 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 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 third quarter of 2023, and in Renminbi terms.

Now, 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, we continued to deliver solid results with our focus on high-quality revenues. Our net revenues increased by 4% to CNY 1.89 billion from the same period last year, mainly driven by the continued growth of our main businesses.

Gross profit was CNY 306.5 million in the third quarter of 2023, representing a decrease of 3.2% from the same period of 2022. Gross margin was 16.2% in the third quarter of 2023, compared to the 17.5% in the same period of 2022. Adjusted cash gross profit, which excludes depreciation, amortization and share-based compensation expenses, was CNY 738.4 million in the third quarter of 2023, an increase of 4.3% from the same period of 2022.

Adjusted cash gross margin in the third quarter of 2023 was 39.1% compared to 39% in the same period of 2022. Adjusted operating expenses, which exclude share-based compensation expenses and compensation for the postcombination employment in an acquisition, were CNY 264.8 million in the third quarter of 2023, compared to CNY 275.1 million in the same period of 2022.

As a percentage of net revenues, adjusted operating expenses in the third quarter of 2023 were 14% compared to 15.2% in the same period of 2022. Adjusted EBITDA in the third quarter of 2023 was CNY 507.9 million, representing an increase of 11.6% from the same period of 2022.

Adjusted EBITDA in the third quarter of 2023 excluded share-based compensation expenses of CNY 9.5 million.

Adjusted EBITDA margin was 26.9% in the third quarter of 2023, compared to 25.1% in the same period of 2022. Our net loss attributable to VNET Group, Inc. in the third quarter of 2023 was CNY 50.5 million, compared to a net loss of CNY 425.2 million in the same period of 2022. Basic and diluted loss were both CNY 0.06 per ordinary share and both CNY 0.36 per ADS. Each ADS represents six Class A ordinary shares.

Turning to our balance sheet. As of September 30, 2023, the aggregate amount of the Company's cash, cash equivalents and restricted cash was CNY 3.02 billion. Meanwhile, net cash generated from operating activities in the third quarter of 2023 was CNY 454.3 million compared to CNY 607.4 million in the same period of 2022. Our capital expenditure in the third quarter of 2023 was CNY 964.7 million.

Before I conclude, I'd like to provide an update on our financial outlook for full year 2023. For the full year of 2023, the Company currently expects total net revenues to be between CNY 7,400 million and CNY 7,600 million, representing a year-over-year growth of 4.7% to 7.6%, and adjusted EBITDA to be in the range of CNY 2,000 million to CNY 2,060 million, representing a year-over-year growth of 6.8% to 10%. This compares with total net revenues expected between CNY 7,600 million and CNY 7,900 million and adjusted EBITDA between CNY 2,025 million and CNY 2,125 million as previously stated.

The outlook update is mainly due to our continuous focus on high quality revenues to maintain the long-term sustainability of our operations. The forecast reflects the Company's current and preliminary views on the market and its operational conditions, and is subject to change.

Moving forward, we will stay focused on our high-quality growth strategy, promoting our premium IDC services to empower digital transformation across a broader swath of industries. As always, we remain committed to creating sustainable growth for all our stakeholders.

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

QUESTIONS AND ANSWERS

Operator

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

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

I would like to have an update in terms of the Company's upcoming convertible bond repayment in February next year. What has been done? Or what is the current progress of the asset monetization to prepare for the repayment? Both for the potential REITs issuance and also the selling down minority stakes of existing projects, et cetera, whatever you can share now.

Qiyu Wang ***VNET Group, Inc. - CFO***

Yes. Thank you. I know this is the most important question for us. Taking the liability management issue has been my top priority task since I took the CFO position. We are busy working on two major ways for resolve the issue. One is raise new funding from new equity and debt investment because we need to follow the NASDAQ rules. So we will be dedicated to pursuing new investors and when it's the right time, we will make the public announcement if there's any concrete progress.

Also we continue to actively engaging with our CB creditors to find the best way forward. We also try our best to present OpEx management and all positive progress in other funding raising, just as you said, including the asset sell minority share and also the C-REITs. Both have some significant progress, but also need some time to closing this deal. So, we will try our best to leverage this incoming CB. So we are firm our plan to the put and are leveraging on both internal and external resources. Thank you.

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

May I follow up with another question on the business update? For the downward revision of the revenue and the EBITDA guidance, where do you see more weakness come from? Is it from the traditional retail business or more from the wholesale business?

Qiyu Wang ***VNET Group, Inc. - CFO***

Yes, we do some change to our guidance. What I want to share is, with close to 13 years of IDC industry experience and market insight, we will be navigating our business towards areas where we focus greater profit margin business in short or mid terms. For example, this year, we have been allocating more of the IDC resources to areas such the AI-driven wholesale business line, where clearly, the booming market and promote our profit margin. So we focus this high profit business and then we try to close some low-profit business.

So you can see, if you compare the revenue and EBITDA guidance, for the EBITDA guidance, we only decreased very minor, around 2%. In addition, we're planning to certain dual- core value within this year, so as our ongoing financial statement could better reflect the nature and transmission of our business. And then we continue to focus the high-profit business, for example, the wholesale and the AI-driven demand business.

Operator

Our next question comes from the line of Charlie Bai from Jefferies.

Charlie Bai ***Jefferies LLC, Research Division - Equity Associate***

This is Charlie Bai from Jefferies. My first question is about third quarter MRR. I saw a quarter-on-quarter decline on both utilization rate and retail MRR. May I know what's the reason behind it?

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

In terms of MRR, I would say for Q3, it still stay at a high level and it's in line with our expectation. There might be some fluctuations from quarter-to-quarter, which is quite normal. So we believe at the end of the year, and it will come up again. And also in terms of utilization rates, our estimate of UR by the end of 2023 will be on par of the Q3 2023 level with a faster growth, especially for our wholesale (corrected by company after the call) customers in the short video sector, we expect a higher utilization rate in 2024.

Charlie Bai ***Jefferies LLC, Research Division - Equity Associate***

May I follow up with another question? May I have some color on the outlook of the CapEx plan this year and in 2024?

Qiyu Wang ***VNET Group, Inc. - CFO***

Yes. This year, the full year CapEx is expected to be around CNY 3.8 billion, which is about 10% more than our guidance. The main reason is that the demand for wholesale data center business is growing faster. And next year, there will be a significant increase in the full year CapEx, mainly due to the increased growth rate of the wholesale business and high AI-driven demand. (corrected by company after the call) So we will announced specific figure of the CapEx in the full year guidance early next year.

Operator

Our next question comes from the line of Timothy Zhao from Goldman Sachs.

Timothy Zhao ***Goldman Sachs Group, Inc., Research Division - Research Analyst***

Sure. I want to understand more about your updated guidance for this year. Just wondering, could you share a little bit more in terms of the revenue breakdown for the full year guidance for your wholesale IDC, retail IDC and also the non-IDC business? And you mentioned that you are going to turn down or reduce the exposure to those low-margin business. Could you elaborate more on what exactly are those lower-margin business? I believe those include the retail business. And like how much more do you expect to reduce the exposure in this segment?

Qiyu Wang ***VNET Group, Inc. - CFO***

Yes. Because the wholesale and the AI-driven demand is increasing faster, so we try to find more resources. For example, in some retail data center, we shut down and we closed some business for traditional retail customer and then moved the space and the power supplied to the AI customer. So this is the main reason for our reduced revenue guidance. And on the same way, (corrected by company after the call) you'll see its impact to EBITDA very minor.

So I think (corrected by company after the call) it is not that the speed of our business is slowed down. On the other way, the signal is that the EBITDA margin and then the EBITDA is more positive than before.

Operator

Our next question comes from the line of Daley Li from Bank America Securities.

Daley Li ***BofA Securities, Research Division - China Software Analyst***

Just one on the AI space. You mentioned more high-power density deployment for your data center. Could you please share the demand trend driven by AI? Do we have any like breakdown, how much demand from AI for the retail or for the wholesale business? And looking into next year, how do we view the AI demand for our data center business?

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

Okay. In terms of AI, which is very popular since this year, we have seen actually the rapid growth of AIGC in China. Dozens of large language models across different sectors has already been launched since early this year. Many of them are still being trained, and the generic models are dominated by actually the internet giants, where the verticals are led by the leading players in specific industries. Some tech start-ups as well, aside from the internet giants.

Back to the impact on our IDC demand. I would say from the wholesale side, the AI-driven demands from wholesale customers are mainly surged by internet giant customers, especially the short video and e-commerce business. Notably, we delivered, as announced this quarter, around 3,500 cabinets during the quarter to two wholesale customers, all of which actually are high-power density cabinets. And in terms of the retail side, we are steadily receiving increasing AI demand from retail customers across various industries, such as local services, healthcare and VR. And also, we are further exploring into the demand from some new economy industries, such as FinTech. We are in dialogue with them.

And in terms of high-power density cabinets, actually, those cabinets from VNET located in the Greater Beijing Area, Yangtze River Delta and also Greater Bay Area. In terms of the size, we obviously see about from up to 40 kilowatts to an over 30 kilowatts for the wholesale and the retail. So far, (corrected by company after the call) from all cabinets we delivered, about over 90% is high-power density.

Operator

Thank you. We have reached the end of the question-and-answer session. And with that, ladies and gentlemen, that concludes our conference for today. Thank you for participating. You may now disconnect your lines. Have a good day.