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PRESENTATION

Operator

Hello, ladies and gentlemen. Thank you for standing by for the First Quarter 2023 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 call is being recorded. I would 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 first 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 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 call today. I will start with an overview of our first quarter results. After that, I will turn the call over to Tim, our CFO, who will discuss our financial results and outlook in more detail.

We got off to a great start in 2023 with a solid first quarter performance, thanks to our effective dual core growth strategy and competitive service offerings. In the first quarter, we sequentially added 1,300 utilized cabinets, growing our overall utilization rate to 56.5% from 55% last quarter. Total cabinets under management reached 87,310 by the end of the first quarter compared with approximately 78,960 one year ago.

Notably, our retail MRR per cabinet reached a record high of RMB 9,486 during this quarter, up from RMB 9,371 million in the previous quarter.

First quarter revenue of RMB 1.81 billion represented an increase of 9.7% year-over-year, and adjusted EBITDA grew about 10% year-over-year to reach RMB 556.2 million, demonstrating our ability to drive stable growth amid China's steady post-pandemic recovery.

Before I talk more about our business results, I want to share some color on the broader macroclimate. Official statistics show China's GDP grew 4.5% year-over-year for the first quarter, exhibiting a clear post-pandemic recovery path. With the digital economy poised to become China's key growth driver in the coming years, China's government is diligently advancing its Digital China vision. Its strategic efforts include taking forward-looking steps in building digital infrastructure, fostering more innovation and value creation in the platform economy, and accelerating digital transformation across a broader swath of the economy and the general population, according to the NDRC.

Given this context, advanced infrastructure facilities such as 5G connectivity and data centers will serve as strategic cornerstones for the development of the digital economy, fulfilling growing demand from a broad spectrum of industries, including internet players, as well as traditional industries. As a leading player in China's IDC space, we are well-positioned to provide ever-improving services to customers and seize opportunities arising from the favorable policy landscape and digital economy boom.

Now let's take a closer look at our first quarter business updates. Execution of our dual-core strategy continues to prove strongly effective in both the wholesale and the retail IDC markets. Our wholesale service offerings continue to gain traction among leading internet players during the quarter.

As we mentioned during the last earnings call, in the first quarter, we won a bid for a new customer, one of China's internet giants, to deploy IDC services to support its business expansion through our IDC assets located in the Yangtze River Delta region. The overall project will total more than 100 megawatts and be delivered in multiple phases. The project is now progressing smoothly and the initial phase of the cabinets will be delivered by the end of this year as scheduled.

This project, once again exemplifies our compelling value proposition and service capabilities for wholesale customers.

Moving on to our retail business. In today's business operating environment, companies of all sizes and sectors are pursuing digital transformation with increasing urgency. Our high-quality, scalable retail IDC service offerings are attracting more and more enterprises demanding fast, reliable and secure digital access to facilitate their digital transformation agendas.

In the first quarter, growing demand from cloud services, media and traditional sectors drove an expansion in our number of new customers. At the same time, we continued to win extended orders from existing customers across a variety of industries, including local services, IT services, online gaming and financial services.

Our comprehensive service offerings and customized solutions create an excellent service experience for customers, solidifying our customer loyalty and boosting our overall competitiveness.

Next, I want to share an update on the Blue Cloud business. In April, Microsoft and our Blue Cloud jointly launched Microsoft Teams, one of Microsoft 365's core modules for the Chinese market. Together with Office 365, Microsoft Teams will be operated under Microsoft 365 by our Blue Cloud in China, bringing more robust and efficient functionality supported by Blue Cloud's secure and reliable cloud services.

As China's digital transformation accelerates, we'll leverage Blue Cloud's cloud operation expertise and decade-long strategic partnership with Microsoft to further unlock its unique value proposition.

Last but not least, I'd like to provide an update on our ESG performance, which is an important part of our growth and long-term value creation philosophy. Last month, we released our third annual ESG report detailing our 2022 ESG initiatives and outcomes, including third-party verification of our carbon inventory results. We also highlighted achievements such as our average annual PUE of 1.37, a green power purchase agreement with a supply guarantee of approximately 500 million kilowatt hours over the next 5 years, and an increase in our percentage of female employees in management positions to 29%.

Going forward, we will continue to deepen our ESG engagement and embrace our responsibility to deliver sustainable value to all shareholders.

In summary, our solid first quarter performance underscores our core strengths and execution capabilities. With China's post-pandemic economic recovery well underway, alongside support from policies designed to boost the digital economy, we are optimistic about the domestic IDC service industry's growth prospects for the rest of the year.

We'll remain committed to our effective dual core growth strategy, focusing on our core business by providing our retail and wholesale customers with reliable and customizable services while fulfilling incremental digital demand to facilitate digital transformations across verticals.

Thank you, everyone. I will now turn the call to 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 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 first quarter of 2023 and in Renminbi terms.

Now let me walk you through the first quarter financial results. Unless otherwise specified, the growth rates of the reviewing are all on a year-over-year basis. We delivered solid results in the first quarter amidst a steady post-pandemic recovery in China. In the first quarter, our net revenues increased by 9.7% to RMB 1.81 billion from the same period last year, mainly driven by the continued growth of our IDC business, as well as our cloud and VPN services.

Gross profit was RMB 352.4 million in the first quarter of 2023, representing a decrease of 0.9% from the same period of 2022. Gross margin was 19.5% in the first quarter of 2023, compared to 21.6% in the same period of 2022.

Adjusted cash gross profit, which excludes depreciation, amortization and share-based compensation expenses, was RMB 754.3 million in the first quarter of 2023, an increase of 10.1% from the same period of 2022.

Adjusted cash gross margin in the first quarter of 2023 was 41.8%, compared to 41.6% in the same period of 2022.

Adjusted operating expenses, which exclude share-based compensation expenses, and compensation for postcombination employment in an acquisition were RMB 228.8 million in the first quarter of 2023 compared to RMB 200.8 million in the same period of 2022. As a percentage of net revenues, adjusted operating expenses in the first quarter of 2023 were 12.7%, compared to 12.2% in the same period of 2022.

Adjusted EBITDA in the first quarter of 2023 was RMB 556.2 million, representing an increase of 9.9% from the same period of 2022. Adjusted EBITDA in the first quarter of 2023 excluded share-based compensation expenses of RMB 8.3 million. Adjusted EBITDA margin was 30.8% in both the first quarter of 2023 and 2022.

Our net income attributable to ordinary shareholders in the first quarter of 2023 was RMB 82.3 million, compared to a net income of RMB 90.7 million in the same period of 2022. Basic and diluted earnings were 0.09 and 0.07 per ordinary share, respectively; and 0.54 and 0.42 per ADS, respectively. Each ADS represents six Class A ordinary shares.

Turning to our balance sheet. As of March 31, 2023, the aggregate amount of the Company's cash, cash equivalents and restricted cash was RMB 3.24 billion. Meanwhile, net cash generated from operating activities in the first quarter of 2023 was RMB 455 million, compared to RMB 482.6 million in the same period of 2022. Our CapEx in the first quarter of 2023 was RMB 611 million.

Next, moving to our outlook. For the full year of 2023, our outlook remains unchanged, with net revenues expected 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 explore new opportunities arising from the robust digital demand and to further strengthen our presence as a leading IDC player. As always, we are dedicated to delivering sustainable value to all of our stakeholders in the long run.

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 - Equity Analyst*

I have 3 questions here. The first one is about the demand and move-in. We see a steady improvement of the utilization rate in first quarter. Does management believe that overall customer move-in will continue to improve further in second quarter? And we have this question because of the overall macro data trending down a little bit in April. So that's why I think there are some concern on the overall demand side. Can management share with us the latest observation in the operation?

The second question is that we observed a few public cloud vendors are cutting their price or unit price recently in the market. And what is the management's view in terms of this kind of a price action transferring to data center, no matter from the volume demand perspective or from the pricing pressure or whatever this kind of commercial negotiation perspective? That's the second question.

The third question is we are glad to see that the company introduced Microsoft Teams in China. And what makes the market more excited is that Microsoft's launch of Office Copilot. Does VNET have any plan to introduce the new generation of AI product to China? Thank you.

Jeff Dong *VNET Group, Inc. - CEO*

Hi Yang, it's Jeff. Let me give you some colors on the 3 questions you just asked. The first one is about the demand. We are glad, as we keep repeating, actually from the macro side such as China reopening, favorable regulatory environments like supporting the development of the platform economy and digital economy. We have seen kind of a trend that's being recovered from the market. But to be honest, given the fact to the real market, we need to be a bit more patient for the market warm-up, to wait it to be fully recovered from the market.

And as we mentioned, we have already obtained a very large order actually from the market as well, which is a signal. You can see we have the ability. And the market has already been recovered, especially from some of the customers like the short video players instead of the other cloud service players.

And second question regarding the cloud service players, you just mentioned price cuts. There's some observations we can share with you. The first, I would say we don't have any direct competition with cloud service players regarding our price cuts as we have a different customer base. The second is the companies we are in several sectors like financial services, they'll only be able to use IDC instead of a public cloud to meet the compliance requirements. I'll take an example.

We recently signed contracts with Morgan Stanley, which is an example, they only can do with IDC instead of the cloud. And plus, in terms of pricing, all the pricing we have signed are already been determined in the contract as well. So we don't see any immediate or direct feedback actually from their price cuts.

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

Actually, my question related here is that do you think their price cut will generate more business volume to overall public cloud and then transfer to IDC suppliers?

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

Yes. We think that will be probably true. We agree with them.

In terms of Microsoft, I would say the Blue Cloud and the Microsoft we recently launched in China. And we would expect the enterprise will build out integrated modern office management system and the intelligent and scalable collaboration platform to help those customers operate efficiently. That's what we're looking for.

In terms of what we got from Teams, we will see what we can do in terms of the income and also the further additional products, add-on from Teams going forward. We'll keep monitoring and after the launch, we will see what we can give to the market immediately.

Operator

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

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

I got 3 questions. The first one is, in the first quarter, you added 1,400 utilized cabinets. Can you share with us the split between retail and wholesale, and what sort of demand you are seeing from retail versus wholesale so far?

And number two is the non-IDC business. Can you actually share some color on the growth of the Microsoft business and the VPN business so far? And what is your outlook in the rest of the year?

And number three is on your CB. That will be puttable next year. Can you discuss whether you have a plan or what are you thinking of in terms of the refinancing of the CB?

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

Thanks Edison, let me take a crack at this, and then I'll have Jeff add additional comments from his side as well. In terms of the additional billable cabinets, I would say that the majority of those additional cabinets are coming from the wholesale business. But that is also not a surprise given the fact that those customers do ramp up in larger volume in terms of cabinets as compared to our smaller-scaled enterprise customers. So again, it's driven largely by the wholesale customers.

Jeff earlier on talked about and we have mentioned for the last few quarters already, a bifurcation in the wholesale customer as well between the cloud service provider customers versus the large internet companies. And I think that more ramp-up and a faster ramp-up with regards to large internet companies. So that would be comprising the wholesale side of that split.

For the non-IDC business outlook, there is continued growth in that business. Obviously, you've seen that Microsoft has launched new products. And so we do expect that will continue to grow. And as that business grows, then obviously our Blue Cloud-related business will grow as well in a similar fashion.

Last but not least, very much aware the market's questions around the upcoming CB for next year, the 600 million CB. We have already received the requisite NDRC approvals. And we actually have a number of both onshore Renminbi as well as offshore U.S. dollar alternatives and solutions in progress. As soon as we have further details, we will then announce them to the market.

Jeff, I don't know if you wanted to add anything else with regard to the retail wholesale growth or the non-IDC business outlook.

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

Yes. I think Tim has already covered most of the part. Just want to add on, in terms of the new added billable cabinets, was contributed mainly from wholesale business as well. In terms of revenue percentage, we cover like 30% from the wholesale and 70% more from the retail. In terms of the capacity and the billable cabinets, AUM is about 40% from the wholesale and 60% from the retail.

And for the Microsoft and Teams related to the ChatGPT, I would say it's really very positive signals to us and we will see more domestic demands, which are required to provide computing power for training. Demand from those models will boost for data centers, especially in the low-tier areas, as latency is not a major concern going forward.

So I think that's probably one of the positive things going forward. And also the higher level of the intra-data center communication, what we call cross connection, which is VNET's one of the unique advantages with enterprise utilizing interconnections to reduce latency. As AI is continuously trained on the new data sets for improved accuracy and response with the information. We would think about this probably be the next direction for the data centers as well. So that's some comments I can share with you on the Microsoft Teams.

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

Is it possible to talk about the growth rate of the non-IDC business in the first quarter?

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

Sorry, you're saying the growth rate of the non-IDC businesses?

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

Yes, in the first quarter. Is it possible for some color on that?

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

I mean we don't give the segment breakdown, but I would say that the growth rate probably would be somewhere in the high single digit.

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

I see. And do you expect that to be similar in the rest of the year?

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

Difficult to say at this moment because, again, if you're looking at the non-IDC business, you're looking at the VPN business but also the Microsoft side. And I think that is the Microsoft side, we do have less visibility. I mean you have visibility around the growth of the underlying business, but only as it is shown to us. So again, we don't have that end connection to the end customer in terms of Microsoft's final business. So hard to say at this moment.

But I would say if you look at the overall trend, first quarter, it's still early. And China is still coming out of COVID. I think after another quarter or so, we probably will have a much better gauge if this is going to accelerate or flatten at the same levels or decelerate in terms of the growth. So we'll have a better idea probably next quarter.

Operator

Our next question comes from the line of Ethan Zhang from Nomura.

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

I have one question. So I note that your retail IDC MRR has been continuously increased since second quarter of last year and already reached around RMB 9,500. So just wonder what's the driver behind the sequential improvement in our retail MRR. And also, could management give us more color on our wholesale IDC MRR? And what's your expectation of the future trends for our pricing?

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

Let me take the first one and then I'll see if Jeff has some color on the second. In terms of retail MRR, I think we've always talked about the fact that we expected the MRR to be north of 9,300 or so, and I think if you look at historical data, it's been up and down a certain quarters. I think in this quarter, in particular, I would say there will be 2 key factors. The first is that there are additional value-added services being added by existing customer cabinets.

So as an example, the increase in O&M services from customers. So that effectively does not increase the total number of underlying cabinets you're dividing by but rather increasing the top, the revenue side. So obviously, the MRR for the overall retail cabinets will go up.

Secondly is that the new cabinets that we are adding are higher MRR cabinets. Again, there is a demand for the colocation and value-added services from our customers. And so that is another trend, I would say, less than the first one. The first one, I would say is a bigger driver for this quarter, is really customers adding to already their suite of services that are being offered by VNET. And therefore, increasing the overall MRR for the segment as a whole. For pricing on the wholesale side and where we see it going, maybe I'll pass that to Jeff to provide some comments there.

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

Yes. In terms of MRR on the wholesale side, I would answer from 2 aspects. One is from the market supply side. As you know, a lot of the smaller players has cut its staff recently, especially since last year. Actually it has helped slow down the supply side as well. And the larger players like us, with some of our other peers, we have also scaled back for the market to make sure we match the supply side, that's one thing we would see from supply-demand side.

And also in terms of pricing of the order. And we do see, especially for the MRR on the wholesale side, it's trend down a little bit. But especially from our analysis, we can see especially since starting from 2023, we see some of the recovery signals actually has come up from earlier of the year. There were a few smaller players in the market, especially some established big players like us have been more cautious about the cash spending.

That being said, we don't blindly go after client deals at any cost which is, to some extent, the pricing will be stable up and down in a certain level. And going forward, from our side, we would do better cost control and also to improve our efficiency to compromise any up and down from the market side.

Operator

Our next question comes from the line of Jasmine Huang from UBS.

Jasmine Huang ***UBS Investment Bank, Research Division - Associate***

I have 2 questions. The first one is on ChatGPT. So I'm wondering if you have seen any growing customer demand or accelerate move-in from recent AI deployment in China? And the second question is on EBITDA margin. So I noticed your Q1 EBITDA margin remained stable year-on-year. So I'm wondering what's the reason behind? And maybe you could mention, please give us some color on the EBITDA margin going forward.

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

So your question on the ChatGPT is whether or not we've seen increased customer demand?

Jasmine Huang ***UBS Investment Bank, Research Division - Associate***

Yes.

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

Yes. I would say it's probably still early stage in terms of the direct impact. There are customers that have announced, obviously, to the market that they're developing relevant products and services linked to the AIGC. Having said that, I would say that it has not yet turned into very tangible new tenders and so forth around that product. So I would still say it's quite early stage.

Secondly, in terms of the EBITDA margins for first quarter, actually, as we mentioned in our earnings release as well, it did also exceed our own internal forecast and expectations, and there are a couple of key drivers. One is there's a seasonality aspect as well. In the first quarter, there are certain nonrecurring revenues that come in or benefits from that, that impact in a positive way the EBITDA and, therefore, the margins.

We also did see some costs that were actually delayed from first quarter into second quarter. And so what you'll probably see is slightly higher than expected margin in the first quarter as compared to if you look at your modeling, lower than what we expected for the second quarter. And that's purely just a timing issue.

Third, which is relevant still, is we've been going through quite a challenging time in our industry. And so we have very much focused on cost controls. And so on our utility side and cost management side, we've been continually rolling out new measures. And so that's a positive again to the margin. So yes, in terms of your overall question, it is in line with last year, but I think there are a number of factors, and again, higher than what we had expected. Does that help to answer the question, Jasmine?

Jasmine Huang ***UBS Investment Bank, Research Division - Associate***

Yes.

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

Let me give you some colors on AI demand, as you mentioned. We do see the trend from AI-based customers as well, but it's mainly from our retail side. Let's take an example. We recently got some feedback from Beijing government agencies, especially around the Beijing area. Those customers with AI-related computing needs is very strong. But it's mainly from a retail side. We are keeping the dialogue with some of the customers with AI-based in nature, but we haven't seen much demand actually from the wholesale side.

Operator

All right, thank you very much for all your questions. And with that, ladies and gentlemen, we conclude our conference for today. Thank you.