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CONFERENCE CALL PARTICIPANTS

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

PRESENTATION

Operator

Good morning and good evening, ladies and gentlemen. Thank you, and welcome to 21Vianet Group's Third Quarter 2017 Earnings Conference Call. (Operator Instructions)

Before we begin, I will read the safe harbor statement. This call may contain forward-looking statements made pursuant to the safe harbor provisions for 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 statements, risk factors and details of the company's filings 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.

With us today are Mr. Steve Zhang, the company's Chief Executive Officer; and Mr. Terry Wang, the company's Chief Financial Officer. At this time, I would now like to turn this conference call over to Mr. Steve Zhang, CEO of 21Vianet. Please proceed, sir.

Zhenqing Zhang ***21Vianet Group, Inc. - CEO & Director***

Thank you, operator. Good morning and good evening, everyone. Thank you for joining us for the earnings call today.

Our core IDC business maintained its steady growth in the third quarter, driven by more demand for computing power and the storage space because of the continuous rise of big data, artificial intelligence, IoT and the mobile Internet. Our self-built cabinets, which have higher gross margins, increased by 302 to 21,273. At the same time, we cleaned up our existing partnered inventory, which have lower gross margins, and reduced partnered cabinets by 239.

During the third quarter, several of our large scale clients further expanded their capacity at our data centers. For example, JD Finance increased its cabinets by around 200 to accommodate its rapid growth in the installment payment or Baitiao business. Ele.me added around 60 cabinets, and Momo added close to 100 cabinets. And Xiaomi remains a loyal customer with over 900 cabinets under management, adding over 100 cabinets this past quarter.

To give some more color on our customers, we segment the market into 3 tiers: start-ups, small and medium-sized business, and large-scale business. While we have a diversified base of customers across all 3 segments, we are seeing some start-ups move to public cloud service providers because of their relatively simple data storage requirements and for increased cost savings. However, as start-ups grow in size, their demands begin to vary and they are no longer satisfied with one-size-fits-all solutions. Small and medium-sized business start to migrate off public cloud and consider hybrid cloud solutions. As this occurs, we approach them and start to cultivate clients among small and medium-sized companies, which have the potential to grow.

As their operations grow further, they start to demand customized solutions and move into IDC centers like ours for 3 reasons: one, data security; two, quality of services; three, value for price. We are uniquely positioned to serve small to medium and large-scale businesses. We actually incorporate their customized requirements into the design of our data centers, so our solutions are tailor-made for each large client from the ground up, such as with our relationship with JD, Jingdong, and Xiaomi. As a result, our customers are not only highly satisfied with the solutions we provide but also remain loyal to us for years to come. As our customers grow, we grow with them.

We believe we have carved out a sustainable niche in the highly competitive IDC market, and we pride ourselves for having 3 competitive advantages: network quality, carrier neutrality and service quality.

First, our network is of extremely high quality both in terms of minimal packet loss during data transmission and a low network latency. For example, if you look at third-party rankings by Bonree, a market network survey company, 21Vianet's data centers are consistently ranked in the top 3 in their 2017 Beijing data center network quality list.

Second, we have a unique edge being both carrier-neutral and cloud-neutral. Our carrier-neutral advantage provides interconnection between multiple telco carriers, while our cloud-neutral advantage benefit customers who deploy their IT infrastructure at our data centers by allowing them to connect directly to various cloud service providers through our cloud exchange. This setting will benefit our customers in diverse and flexible connectivity as well as cost efficiency.

Lastly, we have built a strong reputation with our industry highest-standard quality of services, which not only helps us maintain a high risk retention rate among our existing customers but also helps us attract new customers.

Our partnership with BMW, the world's leading automobile manufacturer, further demonstrates our competitive advantages. In the third quarter, we signed a 5.5-year contract with BMW. Under the agreement, we'll provide a cutting-edge turnkey solution to BMW, which includes hosting, equipment and management services as well as private and hybrid cloud services to support BMW's strong capacity needs in China.

For our managed network services, we completed the divestiture of this business at the end of the third quarter. More importantly, we see the spinoff as a milestone in our development as it enables us to refocus our attention and resources to our core IDC business, strengthen our competitive advantages and fortify our market leadership.

In summary, we are pleased with our accomplishment in the third quarter. We are leaner and stronger than ever before. We'll fully focus on our core hosting and related services business, including IDC, cloud and VPN services. By leveraging our superior network speed, carrier- and cloud-neutral value proposition and our highly endorsed service quality, we believe we'll bring our business to the next level of growth.

With that, I would like to turn the call over to Terry, our CFO, to go through our financial results. Terry?

Shilian Wang ***21Vianet Group, Inc. - CFO***

Thank you, Steve. Before I begin, I'd like to state 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 reconciliation tables included in our press release. Please note that all the financial numbers we are presenting today are in RMB and the percentage change is year-over-year unless otherwise stated.

First, I would like to discuss our financial highlights in the third quarter of 2017. Our total net revenues were CNY 886 million, in line with our guidance. More notably, consistent with our strategy of business realignment and cost control, our profitability in the third quarter continued to improve. Our adjusted EBITDA beat the upper end of our guidance of CNY 122 million and reached CNY 135 million in the quarter. We also saw an increase in our gross margin from 19.3% in the third quarter last year to 21.4% this past quarter.

Moving on to our MNS business. As Steve mentioned, we completed the divestiture of our 2 business units on September 27, 2017. I would like to reiterate the divestiture of our MNS business represents a milestone in our strategic realignment, which allow us to optimize our business structure and refocus on our core IDC business. We expect our operating efficiency to continue to improve going forward. In addition, we will remain prudent on our cost and expenses and continuously enhance our cost-reduction measures. However, in conjunction with our divestiture, we experienced an impairment of our long-lived assets of RMB 402 million, impairment of goodwill of RMB 766 million and disposal loss of subsidiaries of RMB 180 million, all of which were one-time noncash items.

Furthermore, for WiFire Entities, the 6 companies engaged in CDN hosting area network services and route optimization businesses, 21Vianet and its joint venture partners are committed to inject up to RMB 100 million and RMB 200 million, respectively, into these entities within the next 12 months. The injections will be in installments based on the business need of WiFire Entities and can be in a form of equity or a bridge loan depending on the timing of the investment by the joint venture partners. As of November 2017, 21Vianet has already inject RMB 15 million, and 1 joint venture has already inject RMB 30 million into WiFire Entities.

Now let's take a closer look at our quarterly financial results. Our net revenues were CNY 886 million compared to CNY 968 million in the prior year period and CNY 879 million in the second quarter of 2017. Net revenues declined year-over-year due to the decrease in revenues from managed network services, which partially offset by the increase in revenues from hosting and related services.

Our revenues from the hosting and related services increased by 9% to CNY 759 million compared to CNY 699 million in the prior year period and CNY 743 million in the second quarter of 2017. The increase was mainly due to the increase in net revenues from our business line across the segment.

Our total monthly recurring revenue, or MRR, per cabinet for the third quarter increased to CNY 8,571 from CNY 8,311 in the second quarter of 2017.

Hosting MRR per cabinet for the third quarter increased to CNY 7,817 from CNY 7,615 in the prior year period and CNY 7,697 in the second quarter. The main difference between total MRR and hosting MRR is that the former includes revenue from CDN.

Net revenues from managed network services were CNY 127 million compared to CNY 270 million in the prior year period. The decrease was mainly due to increased competition and pricing pressure.

Our adjusted gross profit was CNY 221 million compared to CNY 225 million in the prior year period. Adjusted gross margin increased to 24.9% compared to 23.2% in the prior year period.

Adjusted operating expenses improved by 21% year-over-year to CNY 228 million compared to CNY 287 million in the prior year period. As percentage of net revenue, adjusted operating expenses improved to 25.8% compared to 29.7% in the prior year period.

Sales and marketing expenses improved by 23% year-over-year to CNY 77 million compared to CNY 100 million in the prior year period. The improvement was mainly due to increase -- decrease in third-party channel costs.

General and administrative expenses improved by 20% year-over-year to CNY 130 million compared to CNY 163 million in the prior year period. The improvement was mainly driven by the reduction in headcount.

Research and development expenses were CNY 38 million compared to CNY 36 million in the prior year period.

Our adjusted EBITDA increased to CNY 135 million compared to CNY 68 million in the prior period and CNY 109 million CNY in the second quarter of 2017. Adjusted EBITDA margin increased to 15.2% compared to 7% in the prior year period and 12.4% in the second quarter of 2017. Adjusted EBITDA for our hosting and related services business increased by 41% year-over-year to CNY 176 million compared to CNY 125 million in the prior year period. Adjusted EBITDA for our MNS business was negative CNY 41 million, an improvement of 28% compared to negative CNY 57 million in the prior year period.

Adjusted net loss improved to CNY 69 million compared to CNY 91 million the prior year period. Adjusted net margin was negative 7.8% compared to negative 9.4% in the prior year period. Adjusted diluted loss per share was CNY 0.10, which represents the equivalent of CNY 0.60 per ADS.

Turning to our balance sheet. Our cash and cash equivalent and short-term investment were CNY 1.8 billion.

Now let me provide you with our guidance. Starting from fourth quarter of 2017, we will only provide guidance for our hosting and related services business as we completed the spinoff of our MNS business. For the fourth quarter of 2017, we expect net revenues from our hosting and related services business to be in the range of CNY 740 million to CNY 760 million, compared to CNY 703 million in the prior year period; adjusted EBITDA for our hosting and related services business is expected to be in a range of CNY 160 million to CNY 170 million as compare to CNY 130 million in the prior year period.

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

QUESTIONS AND ANSWERS

Operator

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

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

Congratulations on the beat of the EBITDA in the third quarter. I have a question regarding the MRR. We see sequential improvement for both the hosting and total amount or -- and could you please elaborate more on what is behind that? And how about the outlook going into the next year?

Zhenqing Zhang ***21Vianet Group, Inc. - CEO & Director***

Thank you. First, let me give you our rough outlook for -- going forward. We expect the hosting MRR to be stable. There are some -- a little bit of fluctuation between quarter to quarter. It depends whether the customer are using up the cabinets with high-electricity density or low-electricity density cabinets. But on average, the hosting MRR tends to be stable.

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

I have a second question regarding the next year new cabinet deployment plan. We know that there is some organic addition in term of self-built data center or cabinet. And also, there are some clearing up in term of the partnered data center. What is the overall data center cabinet deployment plan next year?

Zhenqing Zhang ***21Vianet Group, Inc. - CEO & Director***

Let me first talk about our Q4 plan 2017 first. For our Q4 2017, we have 2 large centers that will go into production. Right now, we are in the process of ramping up the inspection before the final deployment. In quarter 4 this year, we will have roughly 2,500 cabinets that will go into deployment to be ready to be used by customers. For 2018, we are still in the budgeting cycle. But roughly, probably, it will be somewhere around 4,000 to 5,000 cabinets next year.

Operator

(Operator Instructions) Your next question comes from the line of Stella Li of Citigroup.

Stella Li

I have 3 questions. The first question is, what would our EBITDA be for the second quarter if we exclude the MNS business?

Zhenqing Zhang ***21Vianet Group, Inc. - CEO & Director***

The second quarter or third quarter 2017?

Stella Li

Second quarter of -- sorry, sorry, for third quarter, third quarter of 2017.

Shilian Wang ***21Vianet Group, Inc. - CFO***

It's about CNY 176 million.

Stella Li

Okay, that's good. So the second question is, we issued U.S. dollar bonds a few months ago. I remember at that time, the company's guidance was this U.S. dollar bond would be for refinancing purpose. So I wonder any of our short-term debt that we already refinanced with the proceeds of the U.S. dollar bond and what would we expect to be the short percent level maybe currently or by the end of this year.

Shilian Wang ***21Vianet Group, Inc. - CFO***

Yes. We have the short term and once we done -- paid the balance of the dim sum bond over -- of RMB 400 million in June, then we -- in August and we renewed about RMB 1.6 billion loans, which already has been -- was borrowed to pay out the last year, the part of the majority of the dim sum bond, CNY 1.5 billion. And that one has been renewed in August, so renewed, about 9 months. So that's short term. And recently, just last week -- yes, last week, we executed to pay out the RMB 1.6 billion loan with our pledged U.S. dollars in Merchant Bank account, so now in the process to redeem that bond, that loan. And I think that will be done within this week. So with that, we have a benefit of saving approximately CNY 70 million interest expense annually.

Stella Li

CNY 70 million interest expense. RMB, you are saying? RMB 70 million, right?

Shilian Wang ***21Vianet Group, Inc. - CFO***

RMB, RMB, yes.

Stella Li

Okay, okay. So you're saying we are in the process of paying down around CNY 1.6 billion loan with the proceed from the U.S. dollar bond expected to complete this week, right?

Shilian Wang ***21Vianet Group, Inc. - CFO***

Right. Because remember, we have a -- we issued a USD 300 million and that's -- we're talking about the proceed of the bond is aiming to pay out the borrowing, CNY 1.6 billion loan. That's our goal for the bond offering.

Stella Li

Sure, very clear. And also, in the third quarter, in the cash flow statement, there is around, like, a CNY 300 million short-term investment. What's that for?

Shilian Wang ***21Vianet Group, Inc. - CFO***

A second.

Stella Li

Payment for short-term investments, CNY 337 million.

Shilian Wang ***21Vianet Group, Inc. - CFO***

We did -- we have a restricted cash and CNY 1.9 billion restricted cash. Once we pay out the CNY 1.6 billion, and the short-term investment is a CD that we deposit and as part of the restricted cash to borrow and we deposit -- we have the cash flow down domestically.

Stella Li

Okay. I see. So it's just kind of cash management, right?

Shilian Wang ***21Vianet Group, Inc. - CFO***

Right. It's part of cash management to be able to support the operation in the short term.

Stella Li

Okay. I see. And there is also another CNY 600 million of derivatives liability as of September. I wonder, what's that for?

Shilian Wang ***21Vianet Group, Inc. - CFO***

You're talking about CNY 677 million?

Stella Li

Yes, yes, the derivatives liability.

Shilian Wang ***21Vianet Group, Inc. - CFO***

Okay, okay. If you look at the balance sheet, the quarter before, it can -- you should see we have a line called -- below the liability -- total liability line is equity section. It's called the redeemable controlling expense interest. That's CNY 700 million, yes. So that -- because of the spinoff and this amount moved to -- up to the liability section. The reason is the -- once we -- remember, we spin off of the last mile of business, which -- this is partly related, our last mile business. Once -- at the time we have -- we sign an agreement with them and they have a put option that -- approximately CNY 700 million. And that will be executed by end of the -- 2019, which is -- CNY 677 million is recalculated through the discount rate to calculate the present value of that put option. And because we spin off, it's -- we're not -- it's not of our own -- or we don't control that company. So that become a liability.

Zhenqing Zhang ***21Vianet Group, Inc. - CEO & Director***

Basically, I think it's -- in 2017, when we acquired the 50% interest in the Aipu business, in the original agreement, there was a put option that we granted to the other shareholder. They can access that put option by end of 2019. But since we spin off that business, we are right now in the process of discussing with the original shareholder to find a solution for this put option.

Operator

(Operator Instructions) Next question comes from the line of Stella Li again of Citigroup.

Stella Li

Sorry. Follow-up questions from me. So for the impairment that we did in third quarter, are they all related to the MNS business? Or there are other -- related to other business as well?

Shilian Wang ***21Vianet Group, Inc. - CFO***

Majority come from the spinoff of the MNS business, only CNY 20 million that -- related to other small investment impairment.

Stella Li

And this impairment, it sounds like -- so next quarter or going forward, we would not be seeing this impairment?

Shilian Wang ***21Vianet Group, Inc. - CFO***

That's correct.

Operator

(Operator Instructions) There are no further question at this time. I would now like to hand the conference back to today's presenter. Please continue.

Zhenqing Zhang ***21Vianet Group, Inc. - CEO & Director***

Once again, thank you for -- thank you all for joining us today. Please don't hesitate to contact us if you have any further questions. We look forward to talking with you in the coming quarter. Thank you.

Shilian Wang ***21Vianet Group, Inc. - CFO***

Thank you.

Operator

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

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