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VNET - Q2 2015 21Vianet Group Inc Earnings Call

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CORPORATE PARTICIPANTS

Terry Wang *21Vianet Group Inc - CFO*

PRESENTATION

Operator

Good morning, ladies and gentlemen. Thank you, everyone and welcome to 21Vianet Group's second quarter 2015 earnings conference call. I would also like to mention that due to the pending going private transaction, there will be no Q&A session at the end of the call.

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 is Mr. Terry Wang, 21Vianet's Chief Financial Officer. At this time, I would now like to turn the call over to Mr. Wang.

Terry Wang - *21Vianet Group Inc - CFO*

Good morning, and thank you for joining us today. And first of all, I am very excited to join the Company's management team as Chief Financial Officer, and look forward to working closely with everyone in the organization during the next phase of 21Vianet's growth.

Similar to prior quarters, before going over the operating details, I'd like to first spend a few minutes to discuss a couple of the market dynamics that we are seeing in the Internet infrastructure segment we serve.

First, new broadband trial licenses. As we discussed last quarter, the central government has set goals to issue 100 new broadband trial licenses, target RMB10b total investments, and expand the numbers of total trial cities to 30, by year-end of 2015.

During the quarter, we have seen some of those new licenses are already being issued, not only to existing broadband service providers, but also to emerging broadband ISPs.

Meanwhile, some of our domestic peers, equipped with cheaper capital resources, continue to be aggressive in promotional activities, especially in the network-related businesses.

As this market is further deregulated, we believe more broadband ISPs and capital will continue to enter this market, introducing incremental competition in the last-mile broadband access market.

Second, improving network efficiency. From a network design perspective, we are seeing the number of the national network access points or NASPs continues to increase from original three, with traffic in the process of gradually diverting to some of the new NASP -- NAPs. Although it will take time to divert China's massive Internet traffic and even longer to make a meaningful improvement in overall network efficiencies, we believe that we are moving in the right direction

With the national broadband plan and a continued push by the government to improve China's network quality, we're seeing the average Internet transmission speed continues to increase, and the average bandwidth costs further decline.

In the backdrop of these industry changes, we continue to see both challenges and opportunities. In the short term, new broadband licenses, improving network efficiencies have resulted in lower bandwidth prices, which have negatively impacted our network bandwidth related businesses, such as MNS and, to a lesser extent Aipu and CDN. However, in the longer term, we believe these changes are necessary components of a transformation to our more advanced [premium] based Internet infrastructure system.

As we continue to adjust our strategies, operations, and organization structure, in light of this transformation, we believe that we are well-positioned to benefit and capitalize on more attractive opportunities over time.

Now let's move on to operating results.

We are pleased to report another quarter of steady growth, as evidenced by total revenues growing by 31.7% year over year, and adjusted EBITDA by 13.2%. At the same time, we had another quarter of strong momentum in datacenter cabinet sales, boosting the datacenter utilization rate by 2.5 percentage points, to 67.5%, and maintain a lower 0.37% hosting churn rate.

These data points demonstrate the strong value of our Internet infrastructure offerings, as well as the operational strength of our [IDS] business.

Looking at our IDS -- IDC business more closely, demand remained strong for our core IDC offerings, as we had another quarter of strong cabinet sales, which exceeded 800. Similar to prior quarters, datacenters in Beijing, such as M6 and [Dajing] continued to witness our strongest recent trends, although we also started to see meaningful sales through improvement in Foshan and Hangzhou datacenters.

However, we note that we experience continued headwinds in MRR as we ramp up the newer datacenters with relatively lower MRR. And we managed, through our industry-wide decline in bandwidth prices. Another challenges we entered -- encountered, however, were delays in cabinets construction, primarily due to additional time required for higher power density cabinets at a couple of locations.

Our operations team are actively working with external parties and looking for ways to streamline the processes, to improve operating efficiencies.

Now let's look at our cloud enabler services. During the quarter, we continued to make progress, by attracting both large customers, as well as smaller, web-direct customers and both Windows Azure, and Office 365 offerings.

Following some of the promotional activities, we are now in the process of converting some of the trial customers into regular, paying customers. In addition, we have signed a strategic partnership agreement with AvePoint, a Microsoft Global Solutions partner, to expand service offerings beyond Azure and Office 365, to our customers.

Although our second quarter cloud revenues did not record a growth rate as strong as first quarter, we note that the year-over-year growth rate still exceeded 50%. Overall, we are happy with the performance of cloud enabler business, which continues to execute well, under the partnership agreement with Microsoft.

Moving on to our CDN business. After a seasonally soft first quarter, this business began to show signs of recovery in second quarter, when we achieved more than [16%] sequential growth rate. However, some projects have been pushed into second half of 2015. With this additional momentum, we expect our CDN business to continue to grow steadily, through the rest of the year.

For our MNS business, as we have mentioned earlier and in prior quarters, we continue to face secular headwinds in this space, mostly due to an industry-wide pricing decline and the greater competition. To that extent, we will continue our network growing -- grooming process, and adapt our business model to changing market dynamics.

For both our CDN and MNS businesses, we have been focusing on organizational transitioning. In the short term, this has led to temporarily greater costs. However, through optimizing our organizational structure and increasing efficiency, we are confident that we can better control costs and nurture our -- this segments, to achieve strong and sustainable growth in the future.

Second quarter was not without its challenges. Our total revenues came in below our own expectations, primarily due to a change in market dynamics, as we discussed earlier, such as declining bandwidth prices, higher competition in certain markets, and the shift in customer needs.

In addition, as a result of the softened revenue and the incremental expenses required in operations, our gross margins were negatively impacted in the quarter. During the quarter, we also had some one-time costs, associated with the organizational transition, which put additional pressure on our margins.

To address these challenges, we are working tirelessly to enhance operational efficiency in a way that maximizes revenues and minimizes expenses. To that extent, we are in the process of putting additional measures of both incentives and accountability with our operations team at various business units.

Going forward, we will continue to strengthen our organizational structure and invest in core growth opportunities, in order to reaccelerate the growth and improve overall profitability in future period, as we fine tune our cost structure and make disciplined investments in expanding our core offerings in an increasingly sophisticated and value-driven market.

We believe we are well positioned to continue to fortify our position as a leading Internet infrastructure service provider.

Now, moving on to our financial results. Before I begin, I would like to state that we present non-GAAP measures today. Our non-GAAP results exclude certain non-cash expenses, which are not a part of our core operations. The details of these expenses may be found in the reconciliation tables included in our earlier release.

As note -- also note that all the financial numbers we are presenting today are in RMB amount, and the percentage change is year over year, unless otherwise noted.

Our revenues for the second quarter of 2015 increased by 31.7%, to RMB866.8m.

Net revenues from hosting and related services increased by 37.9%, to RMB643.7m, primarily due to contributions from acquisitions, an increase in the total number of our cabinets under management, as well as a year-over-year increase in demand for our Company's cloud and CDN services, partially offset by a transition to our value-added tax system.

The MRR per cabinets was RMB9,872 in the second quarter of 2015, as compared to RMB10,031 in the first quarter of 2015. The sequential decline in MRR per cabinet was primarily due to a strong sales of our new cabinets, some of which use lower power and bandwidth during the initial ramp-up, and due to higher contributions from cabinets outside of Beijing, which carry a relatively lower MRR.

Net revenues from managed network services increased by 16.7% to RMB223.1m. This increase was primarily because of the contributions from acquisition, which was partially offset by industry-wide decline in bandwidth prices and transition from or to a VAT system.

Adjusted gross profit increased by 24.2% to RMB245.7m.

Adjusted gross margin was 28.3%, compared with 30.1% in the prior year period and 31.7% in the first quarter of 2015.

The year-over-year and quarter-over-quarter decreases in adjusted gross margin was primarily due to the continued softness in the MNS business, higher spending in telecom, and the electricity costs and the incremental expenses due to organizational transitions.

Adjusted operating expenses increased to RMB209.5m. As a percentage of net revenue, adjusted operating expenses were 24.2%, compared with 20.2% in prior year period and 24.3% in the first quarter of 2015.

More specifically, adjusted sales and marketing expenses increased to RMB74.7m, from RMB56.6m in the prior year period, due to an increase in the number of sales and service personnel in Company's overall business and acquisitions of the businesses with higher sales and marketing expenses.

Adjusted general and administrative expenses increased to RMB97m, from RMB51.8m in the prior year period, primarily due to increased headcounts associated with the growth in the Company's overall business acquisitions with higher general and administrative expenses and incremental expenses related to organizational transitions.

Adjusted research and development expenses increased to RMB30.1m, from RMB24.4m, which reflected our efforts to further strengthen our research and development capabilities, expand our cloud computing and CDN service offerings.

The difference between adjusted operating expenses and our higher GAAP total operating expense amount is primarily due to changes in the fair value of a contingent purchase consideration payable, which was a loss of RMB16.6m and a share-based compensation expense of RMB67.5m.

The changes in fair value of contingent purchase consideration payable resulted from an increase in the present value of estimated cash and share consideration, as at June 30, 2015, associated with our Company's past acquisitions.

From a profitability perspective, adjusted EBITDA increased by 13.2%, to RMB149.4m, from RMB132m in the comparative period in 2014.

Adjusted EBITDA margin was 17.2%, compared to 20.1% in prior year period and 19.4% in the first quarter of 2015.

Our adjusted net loss was RMB16m, compared to adjusted net profit of RMB23.2m in the prior year period.

Adjusted net margin was negative 1.8%, compared with positive 3.5% in prior year period, and positive 2.2% in the first quarter of 2015.

Adjusted diluted loss per share was RMB0.02 which represents the equivalent of RMB0.12 or $0.02 per ADS.

As of June 30, 2015, our cash and cash equivalents and the short-term investment were RMB2.91b, equivalent to $469.6m.

Now I will discuss our updated financial outlook. Currently, we expect the third quarter of 2015 net revenues to be in the range of RMB900m to RMB940m, which at the midpoint represents a growth of approximately 18%, from the comparative period in 2014.

Adjusted EBITDA expected to be in the range of RMB146m to RMB166m, which at the midpoint represents a growth of approximately 1%, from the comparative period in 2014.

We have updated our full-year outlook to reflect the softer than expected first half of 2015 results, and some of the changing industry dynamics. Currently, net revenues from the full-year 2015 are expected to be in the range of RMB3.58b to RMB3.68b, revised from a prior guidance of RMB3.9b to RMB4.1b. The revised guidance from 2015 net revenues at midpoint, represents approximately 26% growth over 2014.

For the full year 2015, adjusted EBITDA is expected to be in the range of RMB620m to RMB660m, revised from prior expectation of RMB760m to RMB860m.

The revised expectation for 2015 adjusted EBITDA at the midpoint, represents approximately 15% growth over 2014. And this forecast reflects the Company's current and preliminary review, which is subject to change.

Lastly, I want to remind the investors of some of the recent developments for 21Vianet.

As was announced in June 10, 2015, the Company received a non-binding going private proposal from Josh Sheng Chen, the Chairman of the Board and the Chief Executive Officer of the Company, Kingsoft Corporation and Tsinghua Unigroup International.

This transaction is currently under consideration. Since receiving the offer, the Company's Board of Directors has formed a special committee to review and evaluate the proposal, and has retained financial and legal advisors in conjunction with the ongoing transaction.

As previously mentioned, due to the pending going private transaction, we will not be hosting a Q&A session on this call today.

This concludes our prepared remarks, and thank you for joining our call today. And now, we would like to conclude the call. Thanks.

Operator

Thank you very much, sir. Ladies and gentlemen, that does conclude the conference for today. Thank you for your participation. You may all disconnect.