THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

VNET - Q4 2016 21Vianet Group Inc Earnings Call

EVENT DATE/TIME: MARCH 09, 2017 / 1:00AM GMT

THOMSON REUTERS

CORPORATE PARTICIPANTS

Steve Zhang *21Vianet Group - CEO*

Terry Wang *21Vianet Group - CFO*

CONFERENCE CALL PARTICIPANTS

Yang Liu *Morgan Stanley - Analyst*

Tien Doe *GIC - Analyst*

Matthew Heinz *Stifel - Analyst*

PRESENTATION

Operator

Good morning and good evening, ladies and gentlemen. Thank you and welcome to the 21Vianet Group's fourth quarter 2016 earnings conference call. (Operator Instructions).

Before we begin, I'll 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 any 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 the conference call over to Mr. Steve Zhang. Please proceed.

Steve Zhang - *21Vianet Group - CEO*

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

Looking back on 2016, it has been an eventful year for the Company, one that was full of many changes and new opportunities. From the investment by Tus-Holdings to the introduction of IBM Bluemix services in China, to the joint venture with Warburg Pincus, those events show the resilience and the resolve of the Company that has experienced certain challenges, but is striving to optimize operations and capitalize on new growth opportunities.

Despite the headwinds we faced in our managed network service business, we were still able to expand our core IDC, cloud and VPN businesses. Looking into 2017, I'm excited for all the new initiatives we have planned, and with the dramatic growth in public cloud adoption, we'll strive to capture all the emerging hybrid cloud interconnection opportunities.

Now, moving on, I would like to touch upon the strategic restructuring of our business, mainly the joint venture with Warburg Pincus and the reshuffling of our business lines.

Most recently, we signed an investment agreement with Warburg Pincus that expands upon the strategic agreement that was previously announced. The framework of the deal remained mostly unchanged as we finalize the details of the joint cooperation. We're still planning on building a digital real estate platform which aims to add 80,000 to 100,000 cabinets within the next five to seven years.

I would also like to reemphasize the numerous benefits of this deal to 21Vianet. Firstly, this deal provides us with an entry point into the wholesale data centre market in which we'll focus on customized data centres for large enterprise customers.

As the data centre industry is transforming very quickly towards such specialization, this segment of the market expect to grow significantly in the upcoming years and we'll be well-positioned to capture the growth in this area. Also, now that our core retail focused collocation and the cloud services will be supplemented with customized wholesale data centre services, we'll be able to offer our customers more complete and expanded selection of service offerings.

Secondly, this deal will allow us to reduce our CapEx as the spending will be shared with Warburg Pincus for future build-ups. With their expertise in the real estate industry, strong financing channels, and the vast international resources, combined with 21Vianet's deep industry experience in data centre operations, it is only a matter of time before we begin capturing these new growth opportunities. Furthermore, significant reductions in CapEx also enables us to focus more on our asset-light business, which will put more emphasis on going forward.

Additionally, we have initiated a reshuffling of our business lines into two independent segments. One segment will be called IDC and Cloud Business, which includes IDC, cloud and VPN services. Through this strategic restructuring, we'll put more focus on our core IDC business and deploy more resources to enhance our hybrid IT service offerings.

Our strong partnerships with public cloud providers allow us to provide our customers a more complete package of interconnection and hybrid cloud services. At the same time, our strong expertise and technology advantage in cloud and data centres enable us to meet customers' need for secure and reliable private cloud solutions. As such, we are well-positioned to provide hybrid IT services that encompass all customer needs.

The other segment will be called Network Business, which will incorporate our managed network services and Aipu business, as well as CDN services going forward. Our focus here is to optimize our network business by boosting revenue and reducing expenses. We'll consistently make improvements to this business that will enhance operating efficiency and ultimately have a positive impact on the Company's profitability.

In addition, this reshuffling will also give a clearer picture of our operations, one that makes sense intuitively to shareholders and investors so that they can make more accurate valuations of our different business lines, as well as properly benchmark us against industry best practices.

Now, taking a closer look at our IDC business. During the fourth quarter of 2016 we added over 300 cabinets in our self-built data centres, and the total cabinets under management increased to 26,380 cabinets. Our hosting churn rate declined to 0.55% in the fourth quarter of 2016 as compared with 0.95% in the previous quarter, which further demonstrates the strong relationships we have with our IDC customers.

Our strong pipeline of cabinets for our self-built data centres and their eventual deployment will enhance our monthly recurring revenues and reignite our top line growth, while pushing us towards margin expansion.

Moving on to cloud. In the fourth quarter of 2016, our cloud business maintained its growth trajectory, which was mainly attributable to the robust results from our partnership with Microsoft and IBM. During Microsoft's Marketing Ignite event in December, we launched Power BI, a cloud service which utilize business data analytics and provides customers with the tool to gain more insight into their business operations. Going forward, as our partners Microsoft and IBM continue adding additional cloud services, we'll expand our wide array of cloud solutions and build upon our cloud-neutral platform.

Lastly, we still witness pricing pressure and intense competition in our traditional MNS and CDN business, but we're seeing signs of price stabilization that bode well for the rest of 2017, and which we expect to help with the recovery of our network business.

Going forward, we'll continue to restructure our overall business by fine-tuning our CapEx structure, running the aforementioned two business lines independently, improving our operating leverage, and providing customers with more value-added services such as hybrid cloud solutions. With the evolving Internet landscape in China and the strong demands for Internet traffic, computing and storage, we believe we are able to solidify our position as a leading Internet infrastructure service provider and meet the ever-changing needs of our customers.

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

Terry Wang - *21Vianet Group - CFO*

Thanks, Steve. First of all, I'm pleased to announce that we met our fourth quarter and full year guidance for both top line revenues and adjusted EBITDA.

Now let me start with our fourth quarter 2016 financial results. Before I begin, I'd like to state that we will 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 reconciliation tables included in our press release. Also note that all the financial numbers we're presenting today are RMB and percentage change is year over year, unless otherwise stated.

In 2016, our total revenues increased to RMB3.64 billion, driven by a 14.2% year-over-year increase in revenues from our hosting and related business. Our net revenues for the fourth quarter were RMB901 million, as compared with RMB983 million in the comparative period in 2015. The decrease was primarily due to decrease in MNS revenues.

Net revenues from hosting and related services increased by 5% to RMB790 million in the fourth quarter of 2016, from RMB755 million in the comparative period in 2015, primarily due to an increase in total number of billable cabinets, partially offset by lower utilization rate and MRR or monthly recurring revenue per cabinet. Our monthly recurring revenue per cabinet for the fourth quarter was RMB8,490, compared with RMB8,696 in the third quarter of 2016. The decrease in monthly revenue per cabinet were mainly attributed to the continued bandwidth pricing pressure.

Net revenues from managed network services were RMB111 million in the fourth quarter of 2016, as compared with RMB229 million in the comparative period in 2015. The decrease was primarily due to RMB107 million decrease in Aipu revenues, which was driven by intensified competition.

Adjusted gross profit was RMB223 million in the fourth quarter of 2016, compared with RMB264 million in the prior period. Adjusted gross margin was 24.7% in the fourth quarter of 2016, compared with 26.9% in the prior period and 23.2% in the third quarter of 2016. The year-over-year decrease in gross margin was primarily due to continued softness in our MNS business.

Adjusted operating expenses were RMB310 million, compared to RMB276 million (corrected by company after the call) in the prior period. As a percentage of revenues, adjusted operating expenses were 34%, compared with 28% (corrected by company after the call) in the prior period and 30% in the third quarter of 2016.

Sales and marketing expenses were RMB92 million in the fourth quarter, as compared with RMB102 million in the comparative period in 2015. The decrease was primarily driven by decreased agent fees. General and administrative expenses were RMB187 million in the fourth quarter of 2016, compared with RMB141 million in the comparative period in 2015. The increase was primarily driven by increased staff cost. Research and development expenses were RMB38 million in the fourth quarter of 2016, as compared with RMB42 million in the comparative period of 2015.

Our adjusted EBITDA for the fourth quarter of 2016 were RMB52 million, as compared with RBM102 million in the prior period. The decrease was primarily due to the increased inclusion of a RMB47 million bad debt provision. Adjusted EBITDA margin for the fourth quarter of 2016 was 5.8%, compared with 10.4% in the prior period and 7% in the third quarter of 2016. Adjusted EBITDA for the fourth quarter of 2016 exclude share-based compensation expenses of RMB57 million and changes the fair value of contingent purchase consideration payable which was a gain of RMB67 million.

Adjusted net loss for the fourth quarter of 2016 was RMB66 million, as compared with adjusted net loss of RMB29 million in the prior period. Adjusted net margin in the fourth quarter of 2016 was negative 7.3%, as compared with negative 3% in the prior period and negative 8.7% in the third quarter of 2016.

Adjusted diluted loss per share for the fourth quarter of 2016 was RMB0.08, which represents equivalent of RMB0.48 per ADS.

I would like to mention that, because Aipu has been underperforming recently due to intensive competition, we incurred a one-time asset impairment expense of RMB390 million, which was included in the operating expenses. This has no impact on our core business and our adjusted EBITDA was not affected by the write-down.

As of December 31, 2016, our cash and cash equivalents and short-term investments were RMB1.5 billion, equivalent to $227 million.

Now, let me provide you with our guidance for the first quarter of 2017. We expect the net revenue to be in the range of RMB820 million to RMB880 million. Adjusted EBITDA is expected to be in the range of RMB65 million to RMB85 million.

For the full year of 2017, the Company now expects net revenues to be in the range of RMB3.7 billion to RMB3.9 billion. Adjusted EBITDA for the full year of 2017 is expected to be in the range of RMB420 million to RMB460 million. These forecasts reflect the Company's current and preliminary view, which may be subject to change.

Finally, I'd like to add that beginning next quarter we will be including segment reporting for our revenues in our financial statements and we may make changes to our operating metrics disclosure. As Steve mentioned earlier, our business line have been separated into IDC and Cloud Business and Network Business, which are operating independently. They are now considered as two separate businesses with different budgets. Our financial statement will be updated to reflect this change accordingly.

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

QUESTIONS AND ANSWERS

Operator

Thank you. (Operator Instructions).

And our first comes from Yang Liu from Morgan Stanley. Please ask your question.

Hello, Yang Liu, your line is open for your question. Please ask.

Yang Liu - *Morgan Stanley - Analyst*

Hello. I have three questions here. The first one is, could you please provide CapEx guidance and the number of cabinets Vianet plans to add in 2017. And what percentage could be shared by the Warburg Pincus JV?

And the second question is, we noticed that you recognized bad debt provision of RMB47 million in the last quarter of 2016. Could you please share about the future schedule on this item, how much bad debt left or on schedule?

Third is that, given the new round of tariff reduction mandates by the government, particularly Premier Li mentioned broadband access fee for SMEs, do you expect another round of significant price cuts ahead versus some stabilization you observed recently? That's all my questions. Thank you.

Terry Wang - *21Vianet Group - CFO*

Thank you. Let me answer the first two questions, and I think Steve will -- might answer the third question.

The CapEx we plan for this year, which is 2017, is approximately around about, as we have two business lines, together, close to RMB600 million. So the Warburg Pincus and -- we have a four data centre joint venture with, and we have the CapEx in there. But for new projects, which is not included in this CapEx for this year, I think that pretty much our cash and given the cash plan and will well support our financial needs for the CapEx for this year.

The second question about debt, about the bad debt, and last year, given that very volatile the market given the competition and the pricing and pressure that we have experienced quite heavy and bad debt provision. But this year, we think that given that the projection in the market, we see stabilized in pricing pressure and the measure we've taken to handle the competition, and we believe that bad debt for this year, provision, will be much less than last year.

So that was all pretty much related the account receivables that were related to major customers were all pretty taken care of in last year. But this year, if you look at the ARs aging, that we cut down to about -- from early year, early, close to 90 days, now down to 70 days. I think this year we're going to have a very good cash --protection for ourselves in related to accounts receivables.

Steve Zhang - *21Vianet Group - CEO*

This is Steve. I want to, before I answer your third question, I want to add that, for your first question. For 2017, right now, in the process of the construction, we have roughly 3,500 cabinets in the construction process. And we haven't -- we are still working with Warburg Pincus on the new build-out which are -- which doesn't include this 3,500 cabinets.

And for the -- our total CapEx, as Terry mentioned, it's roughly around RMB600 million. And in the future, I think Warburg Pincus will share roughly RMB100 million for those CapEx for the existing projects.

Your third question talk about the new tariff reduction. I noticed that in Premier Li's report, he was mostly referring to the mobile roaming charges. And for the broadband, I think the price is already low enough. I think the pricing right now in China is probably the lowest pricing in all Asia region. It's very competitive. That's why we are already experiencing some challenges in our Aipu business.

Yang Liu - *Morgan Stanley - Analyst*

Okay. Thank you.

Operator

(Operator Instructions).

And our next question comes from [Raymond] -- sorry. (Operator Instructions).

And our next question comes from Yang Liu from Morgan Stanley. Please ask your question.

Yang Liu - *Morgan Stanley - Analyst*

Sorry, just one follow-up question. Is the bad debt provision related with your acquired Aipu or other acquired business, or it's related with the core IDC business? Thank you.

Terry Wang - *21Vianet Group - CFO*

Okay, thank you, Liu. The bad debt we'd written down, they're not related to Aipu at this time and not related to IDC customers. So, only related to MNS customers. And we do have Aipu impairment assessment valuation that we put into -- in an earlier release, that's related to the asset impairment assessment.

Yang Liu - *Morgan Stanley - Analyst*

Got it. Thank you.

Terry Wang - *21Vianet Group - CFO*

Thank you.

Operator

(Operator Instructions).

And the next question comes from Tien Doe from GIC. Please ask your question.

Tien Doe - *GIC - Analyst*

Hi. Thank you for the opportunity to ask some questions. You said that you're seeing some stabilization in the CDN business after pretty aggressive pricing pressure last year. Could you give some more details on that? I found that a little surprising and I thought price aggression was still pretty harsh in that business currently.

Second question is just going forward long term, your thoughts on the number of cabinets that you can add on a regular basis going forward. In previous years, you had fairly optimistic cabinet expansion numbers, which you've never met. Going forward, what do you think would be a reasonable assumption on that -- on those numbers of cabinets.

And sorry if I missed this, RMB392 million impairment of long-lived assets, what was that due to? And is there likely to be any figure for that going forward? Thank you.

Steve Zhang - *21Vianet Group - CEO*

Yes. I can answer your first two questions. First, for the cabinets build-out, right now under our construction, we hope to finish in the first three quarters, we have about 3,500 cabinets in the process of being built out. And that doesn't including anything our joint venture with Warburg Pincus planned.

And as we are finished the closing of the joint venture with Warburg Pincus, we are very actively starting the organization structure build-up and our business plan for this year. And I think for the long term, we want this joint venture to provide roughly 5,000 to 10,000 cabinets a year going forward.

Your second question was asking about pricing competition. For our network business, we have two business lines. One is managed network service, which basically we provide bandwidth to ISPs, large ISPs, like China Mobile, the cable industries in China, for the interconnection. I think we found in this space the pricing are being stabilized because there are limited supplies in this market. Regarding the CDN business, yes, competition is pretty intense.

Last year the pricing dropped from over RMB20 per MB to roughly RMB16 to RMB17. And recently we are seeing there are still a lot of players in this market, but we are trying to also increase our network efficiency to continue to face this challenge.

Regarding the RMB390 million impairment, I think Terry will take on that question.

Terry Wang - *21Vianet Group - CFO*

Yes. RMB300 million impairment is the written down based on the fair value assessment, given -- typically we have -- once a year valuation related to our, you know, all the assets, and that in the operation, functioning -- in terms of the functionality or their performance in the business.

So Aipu last year was, you can see that, you know, given the competition that arise and the pricing dropped dramatically, that China Mobile and other players come into the play and we did facing tremendous pressure. So our pricing lower and relatively our coverage getting squeezed. So given that context, that we think that the performance is not as we expected. So we did analysis of fair value, valuation.

So given that valuation, we'd be able to write down RMB390 million on top of our assets. I think that's fair and that gives us the warning that for us to keep the assets maintained, the valuation that we have to do, improve our business in that area so that we -- and we'll need to have a solid plan for that this year. I think that's -- we will, this year, we will -- think that we will get something improved.

Tien Doe - *GIC - Analyst*

Okay. Just one extra question. With that level of cabinet expansion, what would you hope to keep your utilization rates at?

Steve Zhang - *21Vianet Group - CEO*

Our current utilization rate is roughly 75% for self-built data centres. And I think that going forward we will want to continue to maintain a utilization rate above 70%.

Tien Doe - *GIC - Analyst*

All right. Okay. Thank you.

Operator

(Operator Instructions).

Our next question comes from Mr. Matthew Heinz from Stifel. Please ask your question, Matthew.

Matthew Heinz - *Stifel - Analyst*

Hi, thanks for taking the question. A competitor of yours in the CDN business recently reportedly sold its data centre business. I'm just wondering if you were an interested buyer of any of those assets, kind of how you view the portfolio, and whether you expect any change in the levels of competition in the IDC landscape under the new ownership with that business.

Steve Zhang - *21Vianet Group - CEO*

You're talking about ChinaCache data centre sale?

Matthew Heinz - *Stifel - Analyst*

That's correct.

Steve Zhang - *21Vianet Group - CEO*

Yes. Well, that data centre has been up and running for the last two years. I think it's just a new ownership change. And I don't know the new buyers and -- but I think it won't change that much, because that data centre's capacity won't put much impact on this whole market.

Matthew Heinz - *Stifel - Analyst*

Okay. And just the first part, was there any interest on behalf of 21Vianet in buying any of the assets that were up for sale?

Steve Zhang - *21Vianet Group - CEO*

Well, we -- there are a lot of other supplies as well and certainly we are evaluating some of the interesting new data centres that are out there. And we want to match the data centre with our potential customer needs. Because we have a lot of customers and we can get a sense where our customers' future demands are, so that we will either build out or acquire some of the best locations and best properties to meet our customers' demand going forward.

Matthew Heinz - *Stifel - Analyst*

Okay. Thanks for taking the question.

Steve Zhang - *21Vianet Group - CEO*

Thank you.

Operator

(Operator Instructions).

There are no more further questions at this time. I'd like to hand the call back to the speakers for any closing remarks. Please go ahead.

Steve Zhang - *21Vianet Group - CEO*

Thank you all for joining us today, and thank you for your interest in 21Vianet. We continue to have more dialogue with all the investor community. Thank you.

Operator

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