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Q3 2018 21Vianet Group Inc Earnings Call

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PRESENTATION

Operator

Good morning and good evening, ladies and gentleman. Thank you, and welcome to 21Vianet Group's Third Quarter 2018 Earnings Conference Call. (Operator Instructions) We will be hosting a question-and-answer session after management's prepared remarks.

With us today are Mr. Alvin Wang, Chief Executive Officer and President; Ms. Sharon Liu, Chief Financial Officer; and Ms. Rene Jiang, Investor Relations Director of the company.

I will now turn the call over to the first speaker today, Ms. Rene Jiang, IRD of 21Vianet. Please go ahead, ma'am.

Rene Jiang

Hello, everyone. Welcome to our third quarter 2018 earnings call. Before we start, please note that 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.

I will now turn the call over to Mr. Alvin Wang, CEO and President of 21Vianet.

Shiqi Wang ***21Vianet Group, Inc. - CEO & President***

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

Our strategy to focus on our core hosting and related services has resulted in robust financial and operating results. During the third quarter of 2018, our total revenues grew by 14.6% year-over-year to RMB 817 million, and our adjusted EBITDA increased by 81.6% year-over-year to RMB 245 million. More importantly, our EBITDA margin further expanded to 28.2% as a result of our increasing scale and improving operating efficiency.

For our IDC business, they continued to see strong demand in the past quarter, especially in Internet's industry sectors, including new retail, automobile, IaaS and SaaS. In the long run, we believe the increasing prevalence of artificial intelligence, big data, cloud computing and the IoT will continuously boost customer needs for both computing power and storage capacity.

In the third quarter, several of our large-scale customers further expanded their capacity at our IDC centers, including Meituan, Beisen Cloud, PPTV and Vivo. Building on favorable market momentum, they obtained new customers in the rapidly expanding Internet space, including luckin coffee, Bilibili, BaoZun and Qtech as we leverage our industry-leading capabilities in service quality, network reliability and carrier and cloud neutrality.

As our customer base grew in both size and demand, we made preparations to ensure that we can sufficiently meet our customers' requirements for increased capacity, especially in Tier 1 cities. During the quarter, we added around 1,200 cabinets to our self-built network as we completed the delivery of the new data center in Shanghai. At the end of September, the total number of cabinets under our management reached 30,303. While we continued to add self-built cabinets and reduce redundant inventory of our partnered cabinets, we have increased our self-built cabinets as a percentage of total capacity to 84% as of the 30th of September.

As IDC-related regulation becomes more stringent and approval procedures become more complicated in Tier 1 cities, we are expecting certain cabinet deliveries may take longer than we initially expected. However, we remain confident that we can achieve a healthy balance between capacity expansion and a stable utilization this year. Looking ahead, with pipeline resources secured in Shanghai and Beijing, we have the capacity of at least 8,000 cabinets to deliver in 2019 and 2020. Considering additional pipelines and the potential M&A opportunities, we believe we are well positioned to accelerate our capacity growth and strengthen our industry leadership.

In anticipation of potential increases in demand, we are also exploring opportunities to further expand our hosting capability in adjacent cities. We are evaluating resources in satellite cities within approximately 50 to 70 kilometers of Tier 1 cities and quasi-Tier 1 cities with backbone network capabilities. This strategic expansion plan will enable us to better serve our existing customers while establishing a solid foundation for both potential customer additions and future wholesale business development.

Following a thorough review of the wholesale data center market and customer demand, they find it crucial to proving to potential customers that we have sufficient capabilities to meet their requirements in order to seize the incremental growth opportunities available in the wholesale market. As many of you may know, we have made progress on one particular wholesale project. We are currently working with the client to reach an agreement on the terms and technical details. We currently expect this wholesale project to begin contributing to both revenue and EBITDA growth in late 2019.

Moving on to our cloud business. Since we officially launched our Cloud Landing in China in the second quarter, or CLIC strategy, we have designed a suite of unique end-to-end solutions for our customers ranging from regulatory compliance advisory to after-sale services. Our efforts in establishing the best localized platform for international cloud service providers continue to differentiate us from our competitors. As of October 31, over 20 international SaaS providers have selected us to operate their cloud service centers in China. Separately, we also strengthened our cooperation with Microsoft by welcoming their Dynamics 365 and Azure Stack to China in 2019. The launch of Dynamics 365 in China will mark the complete landing of Microsoft's intelligent cloud in the Chinese market. Currently, we are in the early testing stage and may share more information on these products next quarter. With more partners and products in the pipeline, we believe our cloud business should enjoy a healthy growth for the foreseeable future.

Now for an update on our VPN business. Our subsidiary, DYX, has reached an agreement with China Mobile International and the agreement has recently been approved by the China Academy of Information and Communications Technology. We were recently included as one of the first companies in the compliance whitelist, signifying our complete compliance with government regulations. Going forward, we will continue to forge ahead as an industry leader in VPN services, providing high quality network safety, availability, reliability, neutrality and then equality to our customers.

In summary, we have continued to execute our long term growth plan by expanding our capacity to meet the requirements of our growing customer base, establishing a foundation for our wholesale business and enhancing our core IDC business, cloud business and the VPN service. We are confident that we will be able to sustain our current growth trajectory and maintain our leading position in one of the world's fastest-growing IDC markets.

Before turning the call over to Sharon for financial details, I would like to share some thoughts on the macroeconomic environment and the industry conditions. As the current economic environment has become more challenging both globally and domestically, we are closely monitoring the latest movements of our major customers and their business plans in 2019 and beyond. We remain confident in the growth prospect of the Chinese IDC market. We are well prepared for any potential long -- short-term adjustments in customer demands in the coming 12 to 18 months.

Now I would like to turn the call over to Sharon Liu, CFO of our company, to give you more details on our financial results.

Xiao Liu ***21Vianet Group, Inc. - CFO***

Thank you, and hello, everyone. Before I start, I'd like to remind you that since the fourth quarter of 2017, all of our revenues and expenses are entirely generated by our core hosting and related services. To make our year-over-year comparisons relevant and meaningful, in the following remarks we have excluded all revenues and expenses related to MNS business from our third quarter 2017 results.

During the third quarter, we continued to execute our growth strategies to seize emerging opportunities driven by the rising demand for computing and storage capacity and cloud solutions. As a result, our financial performance maintained its solid momentum in the third quarter, highlighted by a 14.6% year-over-year increase in our total revenues to CNY 870 million.

Hosting MRR per cabinet for the third quarter was 8,384 compared to 7,817 in the same period of last year and 8,271 in the second quarter of 2018. The increase in MRR was primarily driven by an increased contribution from our value-added services during the third quarter as well as the migration to more high power density cabinets in general.

Our adjusted cash gross profit, which excludes depreciation, amortization and share-based compensation expenses, increased to CNY 392 million this quarter, representing an increase of 24.2% from CNY 316 million in the prior year period. Adjusted cash gross margin further expanded to 45% from 41.6% in the prior year period. The improvement in adjusted cash gross margin was mainly due to the healthy growth of our total revenues as well as the successful implementation of our efficiency enhancement initiatives.

Adjusted operating expenses increased by 3% year-over-year so CNY 163 million from CNY 158 million in the prior year period. As a percentage of net revenues, adjusted operating expenses decreased to 18.7% from 20.8% in the prior year period.

As our economy of scale improves, our adjusted EBITDA increased substantially by 39.5% to CNY 245 million from CNY 176 million in the prior year period. Adjusted EBITDA margin expanded to 28.2% from 23.1% in the prior year period, showcasing constant improvement over the past 3 consecutive quarters.

Our net loss narrowed to CNY 28 million from CNY 1,479,000,000 in the same period of 2017. Basic and diluted loss per share was RMB 0.04 in the third quarter of 2018, which represents the equivalent of RMB 0.24 per ADS as each ADS represents 6 ordinary shares.

Turning to our cash flow and balance sheet. We generated CNY 261 million positive cash flow from operating activities during the third quarter compared to CNY 207 million in the same period of 2017 and CNY 111 million in the second quarter of 2018. The increased operating cash flow in the third quarter was mainly attributable to the impact of our strict control over account receivables and a tax refund. In addition, our cash and cash equivalents, restricted cash and short-term investments were CNY 2.96 billion at the end of September 2018.

Before giving guidance for the third quarter and full year 2018, I'd like to echo Alvin's point and emphasize that we remain cautiously optimistic about our growth prospect and profitability against the backdrop of macroeconomic uncertainties and Sino-U.S. trade friction. This optimism is due to our highly recurring revenue model, our low customer concentration risk along with the demand inelasticity in hosting and related services for corporate IT infrastructures. We continue to closely monitor our customer's demand to balance revenue and capacity growth. We also closely track the company's account receivable and manage our days of sales outstanding.

Now for the fourth quarter of 2018, we expect net revenues to be in the range of CNY 870 million to CNY 890 million. Adjusted EBITDA is expected to be in the range of CNY 245 million to CNY 265 million. The midpoint of the guidance range indicates a year-over-year increase of 14.9% in revenue and 49.1% in adjusted EBITDA. Consequently, we are raising our full year 2018 guidance to reflect our achievement throughout the year. We now expect net revenues in the range of CNY 3.37 billion to CNY 3.39 billion and adjusted EBITDA in the range of CNY 905 million to CNY 925 million. The midpoint of updated estimates imply an increase of 13.6% year-over-year in total hosting and related services revenues and 36.4% year-over-year in hosting and related services adjusted EBITDA.

This forecast reflects our current and preliminary views on the market and operational conditions, which are subject to change.

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

QUESTIONS AND ANSWERS

Operator

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

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

I have 3 questions today. The first one is we are happy to see the progress in terms of the wholesale business. And could management elaborate more about the strategy in terms of the future development of the wholesale? What kind of customer or location are you targeting? The second one is the VPN business. After DYX becomes fully compliant with the new regulation, what is the revenue growth outlook going into 2019 and beyond? And the third question, go back to the data center part, what is the company's capacity expansion plan in 2019 and the CapEx prepared for the expansion? That's all my questions.

Shiqi Wang ***21Vianet Group, Inc. - CEO & President***

This is Alvin, CEO of the company. Thank you, Liu Yang for your question. Regarding the first question, for the wholesale, of course, we have a very strong belief that the wholesale will be a big, big market going forward. And at the same time, we have discussions with some potential customers. Currently, our strategy, be able to serve the top private cloud customers and also at the same time, raise the Tier 1 international players. In terms of location, currently, we -- our major focus will be Tier 1 cities and also satellite cities close to Tier 1 cities and selected quasi-Tier 1 cities as well. And for the VPN, after the fully compliant with government's regulation, going forward, we will see stronger growth compared to 2018. For the next year, currently, we expect double-digit growth for VPN business across China and also for our entire DYX business. Regarding capacity plan and CapEx plan, I'd like to turn to Sharon to give you more details.

Xiao Liu ***21Vianet Group, Inc. - CFO***

Okay. Thank you, Liu Yang, for your questions. Regarding to our CapEx and capacity plan, as you all know, we have disclosed 2 projects this year, one is in Shanghai and one is in Beijing, and we will deliver around 3,000 cabinets from the second half of next year for the phase 1 of those 2 projects, and we currently also have other pipelines on hand. So the total range cabinets we plan to deliver next year will at least be in the range of 4,000 to 6,000. So for CapEx, including the land and building purchase amount related to Shanghai projects, the CapEx will be in the range of CNY 6 million -- RMB 600 million to RMB 800 million. That amount is based on our current view. And if there is other project pipelines, the amount will change accordingly. We will keep the market updated on that amount. Thank you.

Operator

Your next question comes from the line of Rex Wu from Jefferies.

Rex Wu ***Jefferies LLC, Research Division - Equity Analyst***

I also got 3 questions. So first question is about the cabinet addition plan in the fourth quarter. So by the 9 months 2018, you added about 1,500 cabinets. And what's the outlook for 4Q? And my second question is, in your cash flow statement, I see a payment for investment as a cash outflow and also cash inflow from minority interest. Is this for the JV partnership with Pincus Warburg? And my third question is how about the MRR in the satellite cities? Is there like a big difference compared to Tier 1 cities?

Shiqi Wang ***21Vianet Group, Inc. - CEO & President***

Thank you, Rex. This is Alvin again. Regarding the cabinet capacity increase for -- in the Q4, actually, currently, we have a few M&A projects ongoing. And so some of them are in the very later stage in terms of due diligence and commercial and technical negotiation. We expect to close at least 1 or 2 deals in the coming 1 or 2 quarters. And for the MRR in the satellite cities, we believe that the MRR in the satellite cities will be 10% or 15% lower than Tier 1 cities, but it depends on what kind of facilities and also the power density of the cabinets. So basically, we have strong confidence to serve our customers, especially their future capacity demands with our project -- with our business centers in the satellite cities. So regarding the cash flow question, please, Sharon?

Xiao Liu ***21Vianet Group, Inc. - CFO***

Yes. Hi, Rex. Yes, you are right. The cash out and the cash in amounting to RMB 169 million is related to project settlement in Beijing. We sold 39% of the share of that project to Warburg Pincus and received that amount. And then we injected the same amount to the joint venture with Warburg Pincus to support future business center expansion.

Operator

(Operator Instructions) Your next question comes from the line of Harsh Agarwal from Deutsche Bank.

Harsh Agarwal ***Deutsche Bank AG, Research Division - Head of Asia Credit Research***

I have 2 questions. One is, in your balance sheet, there's a very sharp increase in this item called due to related parties. So if I look at your balance sheet, you have about -- both in the current liabilities and the noncurrent liabilities, you have about CNY 230 million in the current liabilities and CNY 434 million in the noncurrent liabilities. And this is a sharp increase quarter-on-quarter. So just curious what exactly is this due to related parties? And then the second question I had was on CapEx. Again, just to be clear, I might have missed what you said in the previous question. But your guidance for CapEx for this year is CNY 400 million to CNY 500 million, excluding M&A and the wholesale projects. But your 9-month CapEx spend, obviously, has been a lot lower than that. So just curious what do you expect to be the CapEx in the fourth quarter on an organic basis?

Xiao Liu ***21Vianet Group, Inc. - CFO***

Okay, thank you. I will take your question regarding to the amount due to related party. Actually, the amount is related to the long-term lease of the Beijing project we reported to the market last quarter. We signed a 20 plus 20-year long-term lease agreement with the landlord to secure the building for the data center construction. As the landlord is one of the association of tax holding, our controlling shareholder will recognize the transaction as related-party transaction and get the approval from our Audit Committee and the board. For accounting treatment, we treat that transaction as finance lease and we recorded both as PP&E and the amount due to related party accordingly. And for your CapEx -- we have -- actually, we have spent over RMB 300 million CapEx for the past 9 months. And in Q4, the CapEx for data center construction will be around RMB 100 million.

Operator

(Operator Instructions) Your next question comes from the line of Eric Ho from CLSA.

Eric Ho

I just have 2 questions. Regarding the M&A you just mentioned, what's the rough size you estimate that to be? And how are you planning to finance these M&As?

Shiqi Wang ***21Vianet Group, Inc. - CEO & President***

Regarding M&A projects, I mentioned that there are a few M&A pipeline projects. Each single project -- the size of a single project range from 1,000 to 2,000 to 3,000 to 4,000 cabinets. And currently, we have a very strong cash position and of course, we have very close cooperation with financial institutes to financing our M&A activities going forward. Thank you.

Operator

Your next question comes from the line of Rex Wu from Jefferies.

Rex Wu ***Jefferies LLC, Research Division - Equity Analyst***

I just got 2 follow-up questions. So first question is about the cloud demand. So we see -- when we talk to a lot of public cloud providers and they see -- clearly, they see the CapEx slowing down due to the -- like under reservation in some of their self-built hyperscale data centers. So what's your view on -- what's Vianet's view on the, call it, CapEx slowdown and will this impact? Second question is, will the customer, either cloud or traditional IDC customers, start to be more cautious as macroeconomy -- in the macroeconomic uncertainties?

Shiqi Wang ***21Vianet Group, Inc. - CEO & President***

Rex, thanks a lot for your question. It's Alvin here. Regarding the demand from public cloud players, we do have very intensive discussions and communications with our major customers. We receive mixed message. First, they have a strong ambition to grow their business in the coming years and at the same time, they will review their CapEx plan, especially for the coming 3 to 5 quarters. So basically, since -- for 21Vianet, wholesale is a very small part of our total business, and we do have a few pipeline projects with our potential customers. So from that side, so for this pipeline projects, we have strong confidence we can continue to have further discussions and try to secure projects in the coming 1 or 2 years. And for the demand from our retail customers or Internet players, as I mentioned before, we have -- we will be more cautious than before but still remain our -- we remain optimistic. At this stage, we do have discussions with our Internet player customers. They have -- they are more cautious than before, but at this stage, their demand remains strong still for the coming quarter. So we have strong confidence for this year and also we will be -- we will have even further discussions with our major Internet players to see their business plan, their CapEx plan for the next year. Thank you.

Rex Wu ***Jefferies LLC, Research Division - Equity Analyst***

Can I have a follow-up on this? So for the Internet customers, when you talk to them, are they still like will prioritize location like in Tier 1 cities over other things? Or they start to be more rational in investing data centers in Tier 1 cities since there is a supply and demand mismatch and also there is -- the price is much higher in the Tier 1 cities, so maybe they consider to move outside of like Beijing and go to the satellite cities? So is that why you plan to expand in those remote areas? And also, like, which other Tier 1 markets you are still -- you haven't penetrated into but you see a big opportunity there?

Shiqi Wang ***21Vianet Group, Inc. - CEO & President***

So Rex, your question is about the Internet players, you are referring to Internet players not the public cloud players, right?

Rex Wu ***Jefferies LLC, Research Division - Equity Analyst***

Not the public cloud. Not the public cloud.

Shiqi Wang ***21Vianet Group, Inc. - CEO & President***

Okay. Sure. For Internet players, I would say that still there are 2 kinds of customers. One is still in a fast-growing mode and with very strong growth from their business perspective. And for all these Internet players with very strong growth, we see that they have a very strong demand in Tier 1 cities. Basically, they will not consider to move into Tier 2 or remote areas. But for established Internet players, like already publicly listed companies, bigger U.S. dollar market cap companies, and for this -- these ones, they consider to deploy some of their computing capability and storage capacity in lower-cost areas. That's why I said we are considering to serve them with our business centers in satellite cities. But still, that's one of the main reasons that we have -- we are seeing very restricted regulation to build new data centers in Tier 1 cities, especially with big capacity data center in Tier 1 cities. And also, regarding the new growth sectors, I would like to say that for sure, we are very strong in almost all the major Internet sectors. For example, currently, we see very strong demand from new retail, smart vehicles, connected cars and also artificial intelligence. At the same time, going forward, we will establish -- strengthen our capability to meet our financial sector customers going forward.

Operator

(Operator Instructions) There are no further questions. I will hand back to management for their closing remarks.

Xiao Liu ***21Vianet Group, Inc. - CFO***

Thank you, everyone, for joining today's call. If you have any further questions, please contact the company by ir@21Vianet.com. Thank you.