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Q4 2018 21Vianet Group Inc Earnings Call

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PRESENTATION

Operator

Good morning, and good evening, ladies and gentlemen. Thank you, and welcome to 21Vianet Group's Fourth Quarter and Full Year 2018 Earnings Conference Call. (Operator Instructions) 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'll now turn the call over to the first speaker today, Ms. Rene Jiang, IRD of 21Vianet. Please go ahead, ma'am.

Rene Jiang ***21Vianet Group, Inc. - IR Director***

Hello, everyone. Welcome to our fourth quarter and full year 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. Welcome to the earnings call today. We concluded a fruitful 2018 with solid fourth quarter results. Our resilient financial growth and improving operating performance is a direct reflection of our persistent focus on hosting and related services business, service and solution improvement, partnership arrangement and market share attainment.

Our growth is also driven by strong market demand for high-performing IDC and more complex IT infrastructure. Large-scale companies and new corporate players are embracing the new digital transformation. They are increasingly choosing us to satisfy their growing data hosting and computing capacity needs.

During the fourth quarter, we've acquired new customers, including prominent tech firms, such as One Smart(inaudible), T2 Cloud, (inaudible) and Cloud IC, (inaudible) and Yufu Pay(inaudible). In response to customer requirements, we continued to increase our capacity of self-built cabinets. During the quarter, we added around 250 cabinets to our network ending 2018, with a total of 30,654 cabinets. Further, as we just announced, we have observed an increase in demand for geographic expansion beyond the existing Tier 1 cities.

We are excited to expand our geographic footprints to Chengdu, a core network hub of Southwest China. This is our first acquisition since 2014, and it will add over 500 cabinets to our sales pipeline. A broader cabinet network nationwide will also help our planned expansion into the wholesale business at opportune times. We are gauging interest in the market and are currently working on details with potential customers. Although this takes longer than we originally expected, we maintain optimistic on reaching a milestone wholesale agreement this year.

Our non-IDC business continued to grow in 2018. We extended our evergreen cooperation agreement with Microsoft, and we agreed to introduce Azure Stack to China in 2019.

We also launched Cloud Landing in China. As of the year-end 2018, we had offered [over 20] (corrected by company after the call) cloud solutions and features to international SaaS companies. Going forward, we will keep exploring new opportunities that can reinforce our core competency as the partner of choice for international SaaS players.

Finally, on the VPN front, our subsidiary DYX joined the first batch of companies on the government's compliance whitelist. As a result, we are witnessing a gradual recovery of customer inquiries and orders.

Going into 2019. Despite macro headwinds, we remain optimistic about countercyclical nature of our business. On policy side, the government has introduced stricter requirements on data center power usage efficiency. This will increase entry barriers to the industry and lead to more attractive industry consolidation. We believe this is generally beneficial for market leaders like 21Vianet. We believe a strong brand, reliable operating capability help leverage retail and flexible financing channels. Therefore, we are well positioned to compete under government's quota and expand our capacity in key geographic markets.

With a better insight in secured pipeline resources and our execution capability, we are guiding up our 2019 capacity expansion plan to a range a 5,000 to 7,000 cabinets, mostly in Beijing and Shanghai. This updated range includes our recent addition in Chengdu, but excludes potential wholesale projects and M&As. We strive to maintain a delicate balance of capacity expansion with cabinet utilization. At the same time, we prudently assess any potential risks and try to cushion any events beyond our control.

In our 20 years of experience, we have seen that customers' restructuring and merger and acquisitions are inevitable and outside of our control. For example, in early 2019, a major customer of ours decided to terminate its contract with us and move its cabinet capacity to be host by its new parent company. We respect our customer's decision, and we'll cooperate with the move-out. We have been working diligently to reallocate the inventory cabinets. Although we believe the location and quality of these cabinets are attractive to existing and new customers, ramping up those cabinets will take some time. Therefore, we believe our utilization, top line and bottom line in the first half of 2019 will likely experience certain pressure. However, we believe that such pressure will gradually dissipate as we deliver and sell more cabinets throughout 2019.

With that, I will hand the call 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 we start our detailed financial discussion, please note 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 the reconciliation tables included in our press release. Please note that all of the financial numbers we are presenting today are in RMB terms and that percentage changes are on a year-over-year basis, unless otherwise stated.

We concluded 2018 with solid revenue growth, margin expansion, positive cash flow and strong balance sheet, propelled by strong fourth quarter results. Such achievements showcase our business viability and operational efficiency. For the fourth quarter, we grew our revenue by 17.8% year-over-year to RMB 901.9 million, exceeding the high end of our previous guidance range. This growth was mainly driven by gradually increasing demand for high power density cabinet and value-added services.

On the operating metrics, hosting MRR per cabinet rose to RMB 8,457 in the fourth quarter of 2018. The total cabinets under management increased to 30,654 at the end of 2018. Among the total, 25,711 cabinets or 84% are self-built and 4,943 cabinets or 16% are partnered.

Utilization rate in the fourth quarter fell slightly to 70.3% due to cabinet increase in the third quarter and fourth quarter.

Adjusted cash gross profit, which excludes depreciation, amortization and share-based compensation expenses, increased by 27.9% to RMB 409.2 million from RMB 320.1 million in the same period of 2017.

Adjusted cash gross margin expanded by 3.6 percentage points to 45.4% from 41.8% in the same period of 2017, mainly due to the increasing number of higher-margin self-built cabinets in our sales mix and a greater economy of scale.

Adjusted operating expenses, which exclude share-based compensation expenses and changes in the fair value of contingent purchase consideration payable, decreased slightly to RMB 172.4 million from RMB 173.2 million in the same period of 2017.

As a percentage of net revenues, adjusted operating expenses decreased by 3.5 percentage points to 19.1% from 22.6% in the same period of 2017.

Adjusted EBITDA grew by 49.3% year-over-year to RMB 255.3 million, close to the high end of our previous guidance range.

Adjusted EBITDA margin increased by 6 percentage points to 28.3% from 22.3% in the fourth quarter of 2017.

Net loss attributable to the ordinary shares was RMB 114.1 million. Basic and diluted loss per ordinary share was RMB 0.17 and per ADS was RMB 1.02. Each ADS represents 6 ordinary shares.

For the full year of 2018, our hosting and related service business revenue grew by 14.3% to RMB 3.4 billion.

Adjusted EBITDA increased by 36.8% to RMB 917.7 million.

Adjusted EBITDA margin expanded by 4.5 percentage points to 27% from 22.5% in 2017.

Our solid results contributed to strong cash flow and healthy balance sheet. We generated a positive net operating cash flow from -- of RMB 237 million during the fourth quarter. For the full year, net operating cash flow reached RMB 705 million as compared to RMB [487.2 million] (corrected by company after the call) in 2017.

As of December 31, 2018, we maintained a sizable cash position of RMB 2.91 billion, with debt-to-asset ratio of 51.9% as of year-end and debt-to-adjusted EBITDA ratio of 4.1x for the full year, well positioned to moderately lever up to support future growth.

Before giving guidance, I'd like to echo Alvin's point that we remain positive on the growth outlook of the IDC market, as customer demands for cabinet are growing in both scale and geographical coverage. The recent contract termination of a major client brings certain pressure on our revenue and EBITDA, especially during the first half of 2019. However, our sales team will work vigorously to reallocate those vacant cabinets in a timely manner. That said, the uncertainty of our financial numbers has been reflected in our guidance.

For the first quarter of 2019, we expect net revenue in the range of RMB 860 million to RMB 880 million and adjusted EBITDA in the range of RMB 230 million to RMB 250 million.

For the full year of 2019, we expect net revenues in the range of RMB 3.76 billion to RMB 3.86 billion and adjusted EBITDA in the range of RMB 1 billion to RMB 1.1 billion. The midpoint of our guidance ranges indicate year-over-year increase of 12% in revenue and 14% in adjusted EBITDA, respectively. The capital expenditure for full year 2019 is expected to be in the range of RMB 700 million to RMB 900 million. 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) We have our first question from Rex Wu from Jefferies.

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

So my first question is, do we have, like, more clients move out -- potentially moving out have -- like, have the similar reason as the one you just mentioned?

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

At this moment, we don't expect major kind of impact on our revenue except the key customer we mentioned today in the first and second quarter in 2019.

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

Okay. So my second question is about wholesale pipeline. So do you have more customer engagement? Or can you give more updates on the current projects you mentioned during the remark?

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

Actually, as we presented in our prepared remarks, currently, we are engaging with several top customers in mainland China. At this moment, we feel very optimistic to close at least one deal in this 2019.

Operator

Your next question is from Yang Liu from Morgan Stanley.

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

I have 3 questions. The first one, regarding the M&A project in Chengdu. Could management team disclose some valuation multiple for that deal or the project IRR for this case? And second question is, we saw the MRR delivered around 9% year-on-year increase, which looks pretty impressive. Is this still due to the more value-added service or mix change? Or do you have any visibility on when the tight supply in Tier-1 cities start to add your bargaining power? The third question is regarding the Temasek filing. It seems that market worried a lot about this issue last Friday. Could you please help to update the current status of 21Vianet and Temasek?

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

Thank you, Yang. I will answer your first 2 questions. I will make some comments

(technical difficulty)

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

Alvin here. Regarding the Temasek question, actually, we do have a very good communication and relationship with Temasek and especially their [TMT] team. And we have very good conversation these days and also we understand that this termination of their IRR, [investors' rights] agreement didn't indicate any shareholding change plan.

Operator

Your next question is from Stella Li from Citigroup.

Stella Li

I have some questions. We have a U.S. dollar bond that's putable later this year. Do we have any refinancing plan for that one? The second question is, I see the revenue expectation for first quarter 2019 slightly lower than the revenue in the fourth quarter of 2018. Just wondered, is there any particular reason for this? And also third question is, what's your CapEx guidance for 2019 and what's the major usage?

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

I will take your first question.

(technical difficulty)

Stella Li

Hello?

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

Okay. Can you hear me clearly?

Stella Li

No. The line is breaking. I can't hear anything, sorry. Can you repeat?

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

Okay. Okay. Can you hear me?

Stella Li

Getting better.

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

Okay. Okay. Currently, the company has sufficient cash on hand to service the put options. During -- depending on the market conditions and our company's overall financial strategy, we may also consider financing activity to refinance our existing debt. We have no detailed plan and timetable at this moment. Regarding your question related to the CapEx guidance, our 2019 CapEx guidance is from RMB 700 million to RMB 900 million for around 5,000 to 7,000 cabinets. The CapEx including the construction cost and the equipment cost as well as the land and building purchase considerations for our Shanghai [Songjiang] project.

Stella Li

Sure. And the revenue guidance?

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

I'm sorry, the revenue guidance, one reason is that as Alvin and I mentioned in the remarks, we -- one of our major customers terminated the contract with us, and the major customer represented over 2% of our total revenue. That's the major reason for our guidance. Another reason is that certain of our major customers during Q4, they made promotion during Q4, and that promotion will not be occurred in Q1.

Stella Li

A follow-up question. I didn't hear clearly when you mentioned about it, so what's the major reason that the customer terminated the contract with us? And do we expect there can be other terminations from other customers which may affect our revenue?

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

Yes. Actually, this is kind of a special case. One of our key customers, which represents 2% of our revenue in 2018, was acquired by a leading Internet company 1 year -- 1.5 year ago and that -- the parent company made a decision that they will host all their computing capacity in their own in-house capability. And we don't think that will be a very common kind of a case for our major customer base.

Operator

We have a follow-up question from Rex Wu from Jefferies.

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

This is Rex. Sorry, I couldn't hear you about answering the Chengdu M&A -- the Chengdu project and valuation multiple for the project's IRR.

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

Okay, Rex. I will answer that question again. For the Chengdu acquisition, we acquired 500 cabinets, and IRR of that project is around 15%, within the range -- within our acceptable return range.

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

And also the second question about your MRR increase, right, and your overview on the Tier 1 city data center supply and demand?

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

We estimate our MRR per cabinet will remain at the same level of the second half of 2018 for the year 2019. We'll be stable at that level.

Operator

(Operator Instructions) We have [Victor Ong], a private investor.

Unidentified Participant

So I have this question on the Chengdu acquisition. Actually, is the data center up and running data center? Or is this a totally new data center that's waiting for customers to move in?

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

Sorry, Victor, would you mind repeating that question? We didn't quite catch that.

Unidentified Participant

Sure. I understand that 21Vianet, you guys acquired data center in Chengdu with 500 cabinets. So is this data center, like, with customers all moved in? Or we are -- is it a totally new data center that is, like, with no customers right now?

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

Victor, this is Alvin here. Actually, this is a brand-new data center, which we will serve our customers in other locations in -- within our data center network. And also, we are targeting new Internet and other potential customers within Chengdu.

Operator

Your next question is from Hans Huang from Huizhi Capital.

Hans Huang

I have 2 follow-up questions. One is, I just want to double-confirm that the Chengdu's project does not have any client occupied right now, right? And the second question is, can you comment on the reason behind the rising MRR? Is that because there are more VA service provided to the client? Or is that because -- due to the tight supply in the Tier 1 cities?

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

As we said, my -- this is Alvin here. The answer -- the short answer to your first question is, yes, basically, there's zero customer occupation today.

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

Yes, the Chengdu data center is a new data center. And it will be in the ramp-up period from this year and attributed to certain revenue and EBITDA for 2019. I will answer your second question for our MRR. The Q4 MRR increased slightly. It was because of the value-added service as well as the mix shift of the high power density cabinets in Tier 1 cities.

Operator

(Operator Instructions) We have another question from Rex Wu from Jefferies.

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

Just a follow-up on the mix shift to high power density cabinets. So after the major customer moving out, are we, like, planning to sell with these kind of more high power density cabinets or just regular clients? That means, do we see upside to our MRR in the second half of 2019?

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

Rex, we will deliver the new customer, the new 5,000 to 7,000 cabinets from the end of Q3. So it's -- for that new delivered cabinets, they were all in the early stage and can -- although some of them are more high density cabinets, it's 5 kW, but its revenue attribution in the year 2019 is limited. So the contribution to our MRR will be indicated in -- from 2020 and in the following years.

Operator

We don't have any other questions as of the moment. Presenters, please continue.

Rene Jiang ***21Vianet Group, Inc. - IR Director***

Thank you for participating in our call. If you have any further questions, please feel free to contact the company's IR or visit our IR website at ir.21Vianet.com. Thank you.

Operator

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