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VNET - Q1 2016 21Vianet Group Inc Earnings Call

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Stella Li *Citigroup - Analyst*

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PRESENTATION

Operator

Good morning, ladies and gentlemen. Thank you for standing by. Everyone is welcome to 21Vianet Group's first-quarter 2016 earnings conference call. (Operator Instructions). We will be hosting a question and answer session towards the end of this conference 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 observation that involve known and unknown risks, uncertainties and other factors not under the Company's control, which may cause the 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 filing 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 like now to turn this conference call over to Mr. Steve Zhang. Thank you. Please go ahead.

Steve Zhang - *21Vianet Group Inc. - CEO*

Thank you. Good day, everyone, and thank you for joining us today.

First of all, as we recently announced, we are very excited to welcome industry leader Tus-Holdings as a major strategic investor in our Company. Tus-Holdings has built up several industry ecosystems, including a well-established service platform, a financial asset management platform and a research and a consulting platform that covers a broad customer segment, including over 30 university science parks. Those science parks also act as incubators for startups, which may become future 21Vianet clients.

These extensive resources will be highly valuable and complementary to 21Vianet's capabilities and experience as we further expand our IDC, cloud, CDN, VPN and other infrastructure businesses. We remain fully committed to our cloud-neutral, carrier-neutral and customer-focused value proposition and are confident that this investment offers significant strategic value in strengthening in our core operations and expanding new business opportunities.

Now moving on to our first-quarter results. Our top-line growth remains steady as growth in our core hosting business helped to offset continued softness in the network business. Our core IDC business grew by 20% year over year, primarily driven by the solid growth in billable cabinets, improving utilization rate as well as our continued low churn rate. In addition, demand for cloud services remains solid thanks to the growing popularity for the Windows Azure and the Office 365 product offerings.

But, as expected, this growth was offset by our MNS business, which continued to adversely impact our revenue growth. Even though we continued to experience solid growth in our bandwidth volume, bandwidth pricing continued to be under significant pressure due to intensified market competition.

Let's go over each of our core businesses in more detail. For our core IDC business, our cabinet capacity continued to grow but at a slower rate. While a temporary delay in new datacenter construction was the main cause of the slowdown in new cabinet adds, we expect new cabinet growth to reaccelerate in the coming two quarters. Meanwhile, our billable cabinets under management continued to increase, which helped further improve our datacenter utilization rate to 74.6%. Our hosting churn rate remains at a relatively low level of 0.4% in the first quarter.

Additionally, we continue to add new customers and expand capacity for existing customers. Our customer pipeline remains strong as we work with several fast-growing industry leaders to further strengthen our various verticals, including emerging technology companies, financial services, multinational enterprises and carriers. For example, Didi, a leading ride-hailing service, and Ele.me, an O2O meal operating -- meal ordering services and food delivery have helped drive our volume growth.

Now, for cloud business, we are pleased to see our cloud service continue to show impressive progress thanks to further traction with the Microsoft Windows Azure and Office 365 product offerings. We believe we have built a comprehensive portfolio of services which appeals to a wide range of users and have established a well-recognized brand as one of the most trusted providers of cloud computing and datacenter services for multinational companies operating in China. We aim to build upon this foundation in future periods in order to further expand our customer base and the product offering.

For our CDN business, even though we faced seasonal weakness in the first quarter, we continue to fine-tune our growth strategy and execute our marketing initiatives in order to catch up with industry leaders. We have established a portfolio of security products, with strong adoption rates and have received positive feedback from many of our customers. Additionally, we are working diligently to optimize our cost structure in light of the continued decline in bandwidth price in this market.

Our VPN business continued to grow steadily in the first quarter, thanks to increasing demand from both domestic and international customers. Going forward, we will continue to leverage cross-selling opportunities to [strengthen DYXnet's] position as a leading enterprise VPN service provider in the Greater China region.

Moving on to our MNS business, net revenues from managed network services came in soft, primarily due to the continued industry-wide decline of bandwidth prices and intensifying market competition, as discussed in previous quarters. During the first quarter we began streamlining the Aipu Group and have trimmed some lower-margin equipment-based revenue, which negatively impacts at the top line. MNS business remains one of the most challenging parts of the overall business. To that end, we'll continue our network grooming process and restructuring our business to suit the changing market dynamics.

During the first quarter, we continued to invest in the core growth areas, such as IDC and the cloud business, in terms of both capital expenditure spending as well as R&D capabilities as these remain core growth engines for the Company. Meanwhile, we have continued to restructure several business lines, especially in the bandwidth-related business, such as CDN, [Aipu] and our MNS business, to more effectively align our cost structure with changing market dynamics.

Looking ahead at those challenges we currently face in the market and our overall business development, a key focus for us has been to restructure our business in order to better serve the continuously evolving and increasingly specialized market segment. We believe this autonomy will further improve scale, profitability and operating efficiency in each of the specific units. As we continue to expand our datacenter footprint and leverage our strong partnerships with global tech companies, we are confident that we can reignite growth and [profitability] and maintain our position as a leading Internet infrastructure service provider in China.

At this point, I would like to turn the call over to Terry, our CFO, to go through our financial results. Terry.

Terry Wang - *21Vianet Group Inc. - CFO*

Thanks, Steve. Now I want to discuss our first-quarter financial results. Before I begin, I'd like to state that we would present the non-GAAP measures today. Our non-GAAP results exclude certain non-cash expenses which are not a part of our core operation. The details of these expenses may be found in our reconciliation tables included in our earlier release. Also note that all the financial numbers we are presenting today are RMB amount and the percentage change is year over year unless otherwise noted.

Our revenues for the first quarter of 2016 increased by 0.3% to RMB862m and net revenues from hosting and related services increased by 15% to RMB706m from RMB613m in the comparative period of 2015, primarily due to a year-over-year increase in total number of billable cabinets and improved utilization rate.

MRR per cabinet was RMB9,115 in the first quarter of 2016, compared with RMB10,030 in the fourth quarter of 2015, primarily due to the bandwidth pricing compression as well as the addition of several large new customers in the regions where we have a lower pricing power.

Net revenues from managed network services were RMB156m in the first quarter of 2016 as compared to RMB247m in the comparative period in 2015. The decrease was primarily due to the continued industry-wide decline in the bandwidth pricing.

Adjusted gross profit was RMB211m compared with RMB273m in the comparative period in 2015. Adjusted gross margin was 24.5%, compared with 31.7% in the comparative period in 2015 and 26.9% in the fourth quarter of 2015. The decrease in the gross margin was primarily due to higher spending on telecommunication services and the continued softness in the Company's MNS business.

Adjusted operating expenses increased to RMB220m from RMB209m in the comparative period in 2015. As a percentage of net revenue, adjusted operating expenses were 25.5%, compared with 24.3% in the comparative period in 2015 and 28.1% in the fourth quarter of 2015. More specifically, sales and marketing expenses decreased by 15% to RMB77m from RMB90m in the comparative period of 2015, primarily due to reduced sales agency fees.

General and administrative expenses increased by 4% to RMB134m from RMB129m in the comparative period in 2015, primarily due to increased staff cost, partially offset by lower consulting fees.

Research and development expenses increased by 23% to RMB42m in the first quarter of 2016 from RMB34m in the comparative period in 2015, primarily due to investment in key strategic growth areas.

Change in the fair value of contingent purchase consideration payable was a loss of RMB2m in the first quarter of 2016, compared with a loss of RMB21m in the comparative period in 2015.

From a profitability perspective, our adjusted EBITDA for the first quarter of 2016 was RMB100m -- RMB109m, compared with RMB167m in the comparative period in 2015. Adjusted EBITDA margin for the quarter was 12.6%, compared with 19.4% in the comparative period in 2015, and 10.4% in the fourth quarter of 2015.

Adjusted net loss for the first quarter of 2016 was RMB74m, compared with adjusted net profit of RMB19m in the comparative period in 2015.

Adjusted net margin was negative 8.6%, compared with 2.2% in the comparative period in 2015, and a negative 3% in the fourth quarter of 2015.

Adjusted diluted loss per share for the first quarter of 2016 was RMB0.14, which represents the equivalent of [RMB0.84] (corrected by company after the call) per ADS.

As of March 31, 2016, our cash and cash equivalents and the short-term investment were RMB1.24b, equivalent to $192m.

This concludes our prepared remarks for today. Operator, we're now ready to take questions. Thank you.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Colin McCallum, Credit Suisse.

Colin McCallum - *Credit Suisse - Analyst*

Hi there. Thanks for the opportunity. I have a couple of questions. First of all, I think you mentioned in the MD&A that there's a couple of -- I think you used the word non-recurring factors. Could you quantify the non-recurring factors in first quarter? Is that on the cost side? And how much are we talking about in RMB million? That's first question.

Second question is a related one. You used to generate around about a 19% EBITDA margin -- adjusted EBITDA margin. It's now, in first quarter, 12%. What exactly has happened to your business? And is 12% now the profitability that you get from your business or is there some -- going back to the first question, is there something exceptional that's happening to mean that you've lost 7 percentage points of your profitability. That's the second question.

Third question, how much cloud revenue was there in the first quarter of 2016?

And fourth question, what will be your intended cabinet build for this year in terms of number of cabinets you think you can build? That was all I had. Thank you.

Terry Wang - *21Vianet Group Inc. - CFO*

Let me take the question number two. Number one, you're talking about merger/acquisition for the first quarter. I think that non-current things that we had last quarter, we had pretty much around about RMB30m, which includes some of the write-off on the account receivables and some of the compensation-related one, the -- and that's [true to us] for the year. And this year -- this quarter, relatively, and we didn't have the major M&A activities in the first quarter. So I think that going forward we might have some of the activities going on. That's first question.

The second question, I think that you mentioned that the EBITDA got impacted from the year-over-year comparative period, from 19% down to 20% -- 12%. I think the major reason, as we stated, is driven mainly because of the continuously and very rapid decline in the pricing and from the bandwidth area. So very -- it's been an environment -- a market environment for last four years, and it's because competition and some sort of regulation changes. So that triggered the bandwidth pricing erosion for quite a long time. That's the major reason.

The other reason is I think that the -- even though we control our cost, but on the purchase side, the cost -- the pricing -- the purchase price relatively, and drop is not as fast as revenue and pricing drop. So that's why the margin is being squeezed and the EBITDA has been -- and the management impacted.

But going forward, then I think that we see -- we have some measures we take and we will see the results come out, especially in the second half of the year. And we'll see the improvement in margin side and also the other businesses. We will reenergize our business in the top line and to see the most profitable business that we will expand. And the profitability shrinking area we will watch carefully and we'll control the level.

Colin McCallum - *Credit Suisse - Analyst*

Could I just come back a little bit there? So I think I understood what you said. Are you saying basically that your MNS business, you have locked in some pricing with your customers and you have locked in some pricing with your suppliers, I guess the telcos? And are you saying that the price that you give to customers has come down very quickly on MNS but you're locked into paying more to your suppliers?

And therefore are you saying there's a mismatch in timing, that you haven't been able to renegotiate down the pricing of the bandwidth as quickly as the pricing on your services has come down? Is that what you're saying? And is that something that you can change over time or is it something that is structurally -- you can't change?

Steve Zhang - *21Vianet Group Inc. - CEO*

Let me take this question. Yes, you are right. For the first quarter, we definitely still have the old cost structure with our suppliers. And we are optimizing that in the second quarter and we expect that we will reduce our cost structure with our suppliers in the second quarter.

Hello?

Colin McCallum - *Credit Suisse - Analyst*

Yes. Thanks for that. And then on your cabinet?

Steve Zhang - *21Vianet Group Inc. - CEO*

Yes. The cabinet build for this year, our plan is roughly 6,000 new cabinets. The majority will come in in the third quarter and the fourth quarter this year. We'll have roughly 400 new cabinets coming in in the second quarter as well.

Colin McCallum - *Credit Suisse - Analyst*

Got it. And just quickly on cloud revenue, can you give us a number for that in the first quarter?

Steve Zhang - *21Vianet Group Inc. - CEO*

Cloud revenue, I think based on our agreement with Microsoft, we normally -- we cannot really disclose the cloud revenue.

Terry Wang - *21Vianet Group Inc. - CFO*

But we can talk about the growth. We have a growth of quarter over quarter and about -- at least 10% -- between 10% to 15% growth from last quarter and -- quarter four.

Colin McCallum - *Credit Suisse - Analyst*

Got it. Okay. Thanks very much.

Operator

(Operator Instructions). Stella Li, Citigroup.

Stella Li - *Citigroup - Analyst*

Hi. Thank you very much for taking my questions. I want to understand a bit more about the potential strategic investment from Tus-Holdings. Given that if the transaction is completed, they will hold around 51% of our voting power, just wonder that does that mean and my understanding is right that this 51% voting right will trigger the change of control of the CNH bonds of our Company, and that investors -- bondholders may have the right to require the Company to call back the bond? This is my first question.

And the second question is if the transaction is complete, do we expect any change on the Board of the Company as well? That's it from me. Thanks.

Terry Wang - *21Vianet Group Inc. - CFO*

Let me take that one. Yes, the 51% can trigger the change of control. That will trigger the callback, the Dim Sum bond given the agreement with our bondholder. But the timing -- we have the timing difference so that after -- basically we will take a couple weeks to get the transaction complete. And afterwards we would take another 30 days and give the bond a notice and -- to call, notice to notify the change of control. That's one.

The other second question that we have, we will some -- have minor changes in the Board seat.

Steve Zhang - *21Vianet Group Inc. - CEO*

Tus-Holdings will have the right to nominate one Board Member. And they also have the right to nominate one Independent Board Member.

Stella Li - *Citigroup - Analyst*

Okay. Just one follow-up question from me. If the early redemption of the bond is triggered, what kind of financial resources we have to prepare for that?

Terry Wang - *21Vianet Group Inc. - CFO*

Given that we -- remember we had the convertible bond that we signed agreement a couple weeks ago? That's one of the sources we prepare. The other one is that we have some money outside, offshore. And plus that $388m from Tus-Holdings for the equity investment. So we do have money for them if they want the early callback, the early redemption of the bond.

Stella Li - *Citigroup - Analyst*

Okay. Understand. Thank you very much.

Terry Wang - *21Vianet Group Inc. - CFO*

Thank you.

Operator

(Operator Instructions). Liu Yang, Morgan Stanley.

Liu Yang - *Morgan Stanley - Analyst*

Good morning, management. I have a question about the privatization deal. Given the change of the majority voting power after the investment from Tus-Holdings, do you expect there's any change in this transaction -- privatization transaction? Thank you.

Steve Zhang - *21Vianet Group Inc. - CEO*

As of today, we have not been informed by the buyer groups or the special committee of any change on the going private transaction deal.

Liu Yang - *Morgan Stanley - Analyst*

Okay. Thank you.

Steve Zhang - *21Vianet Group Inc. - CEO*

Thank you.

Operator

(Operator Instructions). There are no further question at this time. I would like to hand the conference back to our presenters. Please go ahead.

Terry Wang - *21Vianet Group Inc. - CFO*

Thank you, and thank you, everyone. And if anyone can have a follow-up call, then please contact us and we will take that call as much as we can. Thank you.

Steve Zhang - *21Vianet Group Inc. - CEO*

Okay. Thank you.

Operator

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