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

PRESENTATION

Operator

Good morning and good evening, ladies and gentlemen. Thank you, and welcome to the 21Vianet Group's Second Quarter 2017 Earnings Conference Call. (Operator Instructions)

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 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 this conference call over to Mr. Steve Zhang. Please proceed.

Zhenqing Zhang ***21Vianet Group, Inc. - CEO & Director***

Thank you, operator. Good morning and good evening, everyone. Thank you for joining us for the earnings call today. Our business realignment continued to generate fruitful results in the second quarter of 2017. Our core hosting and related services business continued its solid growth momentum in the quarter as revenues increased by 11% year-over-year, while our managed network service business continue to face competitive challenges and the pricing pressure. We continue to optimize this business by actively implementing various measures to control our cost and reduce expenses. Going forward, we'll explore and evaluate strategic alternatives for MNS business.

Now let me update you on our core hosting and related service business, which includes IDC, cloud and the VPN services.

For our IDC business, we continue to see strong demand in this market, driven primarily by increased computing power and the storage needs from the rise of big data, mobile Internet and the Internet of Things. For example, our enterprise clients are relying more and more on big data to support their business intelligence applications, which will create a lot of demand for computing and the storage capacity, resulting in the need for more data centers. To capture this growing demand, we'll increase our data center capacity through a variety of channels, including building cabinets ourselves and entering into strategic joint ventures.

In the second quarter, we added 967 cabinets, resulting in a total of 27,361 cabinets under management. Our self-built cabinets, which have higher gross margins, increased by 1,453. At the same time, our partnered cabinets, which have lower gross margins, decreased by 486 in the second quarter. In addition, our hosting churn rate decreased from 0.48% to 0.24% this past quarter.

We were also able to expand our customer base in the second quarter through a new cooperation with the Payment and Clearing Association of China. They operate an online payment clearing platform called WangLian, which clears payments made by non-bank, third-party payment agencies such as Alipay and WeChat Pay. Through this cooperation, they have selected 21Vianet to host their servers in Beijing, Shanghai and Shenzhen. Furthermore, because of the growing popularity and the usage of some of our client applications, such as Eleme and Didi, we have seen increased demand for cabinet space from our existing client base.

In terms of our partnership with Warburg Pincus, as previously mentioned, it is a long-term partnership and everything is progressing on track. During the second quarter, we almost completed transferring another one of the 4 high-quality data center assets into the initial joint venture. In the long term, we still plan on reaching 80,000 to 100,000 cabinets within the next 5 to 7 years to build out our digital real estate platform.

Going forward, we want to expand our product offerings to improve customized wholesale data center solutions as we expect this segment of the market to grow significantly, and that we want to be well positioned to capitalize on this trend.

This past quarter, we continue our efforts in hybrid IT services to encompass all of our customer needs. For example, by leveraging our partnership with public cloud providers and our strong technology advantages in cloud and data center, we were able to deepen our business relationship with Xiaomi. Furthermore, we strengthened our cooperation with both AliCloud and Tencent Cloud. We now have fiber connectivity between 21Vianet data centers and those of Alibaba and Tencent. Those direct links allow us to offer more Internet security solutions to our clients with features such as Anti-DDoS.

Moving on to the MNS business. In the past few years, we have experienced increasing competition and the pricing pressure. I would like to give some more color on this current industry environment.

For our Aipu business, it has become significantly more challenging to compete in the last-mile fixed broadband industry since China Mobile entered this market. China Mobile has issued a fixed line broadband license from the [MIIT] in December 2013. And since then, they have been employing aggressive strategies to gain market share from incumbent players, such as China Telecom and China Unicom. This has directly adversely affected our Aipu business as our subscribers have moved to cheaper, more attractive plans offered by China Mobile. In the near term, we do not see any changes to this trend.

For our CDN business, we have also faced increasing competition, specifically from cloud providers such as AliCloud and Tencent Cloud. They are taking aggressive measures to cut prices, resulting in lower profitability for all CDN providers. This is causing a massive shake-up in the CDN industry, with all third-party providers being adversely affected. Despite the unfavorable industry backdrop, we are moving forward with our restructuring plans as we implement strict cost control measures by reducing headcount and renegotiating bandwidth contracts with telecom operators to further optimize the network business, and we will continue to explore strategic alternatives for this business.

Overall, we are pleased with the solid results we achieved in the second quarter, which, once again, demonstrate the effectiveness of our restructuring and the business realignment. I want to emphasize that we'll continue to invest in our core IDC business because of the strong demand from our existing and the prospective clients. By focusing more on the core business, we have already seen robust business and the financial growth in this segment through improvements in our operating numbers, financial margins and cash flow. Going forward, we'll continue our restructuring efforts and explore different strategic options and the alternatives for the challenging MNS business.

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

Shilian Wang *21Vianet Group, Inc. - CFO*

Thank you, Steve. First off, let me give you some financial highlights. Our total net revenues were RMB 879 million, which met our guidance for the second quarter. Even though this was a decrease of 3.5% year-over-year, it represented a increase of about 2% quarter-over-quarter. More specifically, revenues from our core hosting and related services increased by 10.9% year-over-year and 5.2% quarter-over-quarter. Even though we faced a challenging market conditions in our MNS business, due to our business realignment efforts, we were able to control costs and reduce expenses resulting in improved profitability in the second quarter.

Our gross profit increased by 8.8% year-over-year to RMB 188 million, and our gross margin expanded to 21.4% from 19% a year ago.

Our adjusted EBITDA also increased to RMB 108.6 million, a significant improvement year-over-year, and an 8.3% increase quarter-over-quarter. Moreover, we intensified our cash collection efforts. As a result, our accounts receivables declined sequentially and a year-over-year to RMB 674 million as of June 30, 2017. We were also able to generate RMB 69 million of net cash from operating activities during the second quarter.

Going forward, we'll remain committed to our business restructuring. We will continue to optimize our cost and expense structure while striving to revive our total revenue growth.

I would like also to mention that we complete our 3-year bond offering for USD 200 million at an interest rate of 7%. Given the challenging market conditions that we faced, we are pleased with the final offering size and coupon, especially since we saw a similar recent deal in the market pricing much higher or at a much slow -- smaller offering size.

Now let's take a close look at our quarterly financial results. Before I begin, I'd like to state that we will present the non-GAAP measures today. Our non-GAAP results exclude certain noncash 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. Please note that all the financial numbers we are presenting today are in RMB, and the percentage change is year-over-year, unless otherwise stated.

Our net revenues were RMB 879 million compared with RMB 911 million in the prior year period, and RMB 862 million in the first quarter of 2017. Net revenues slightly declined year-over-year due to the decrease in the revenues from Managed Network Services, which was partially offset by the increase in revenues from hosting and related services.

Net revenues from hosting and related services increased by 10.9% year-over-year to RMB 743 million compared with RMB 670 million in the prior year period, and RMB 707 million in the first quarter of 2017. The year-over-year increase was mainly due to the increase in the revenues from our IDC and VPN business.

Our monthly recurring revenue or MRR per cabinet for second quarter was RMB 8,311 compared with RMB 8,363 in the first quarter of 2017. The decrease in monthly recurring revenue per cabinet was mainly attributable to lower bandwidth pricing. This quarter, we also began to disclose MRR for our hosting business.

Hosting MRR per cabinets for the second quarter was RMB 7,697 compared to RMB 7,746 in the prior year period and RMB 7,598 in the first quarter. The main difference between Hosting MRR and total MRR is that the latter includes revenues from CDN.

The net revenues from Managed Network Services were RMB 135 million compared with RMB 240 million in the prior year period and RMB 155 million in the first quarter of 2017. The year-over-year decrease was mainly due to increase in competition and the pricing pressure.

Our adjusted gross profit increased by 9.2% to RMB 219 million compared with RMB 201 million in the prior year period. Adjusted gross margin increased to 25% compared with 22% in the prior year period.

Adjusted operating expenses decreased by 17.7% to RMB 258 million compared with RMB 313 million in the prior year period. As a percentage of net revenues, adjusted operating expenses decreased to 29.4% compared with 34.4% in our prior year period.

Sales and marketing expenses decreased by 15.1% to RMB 71 million compared with RMB 83 million in the prior year period. The decrease was mainly driven by a decrease in the third-party sales commissions.

General and administrative expenses decreased by 10.1% to RMB 139 million compared with RMB 155 million in the prior year period. The decrease was mainly driven by a reduction in headcount.

Research and development expenses were RMB 43 million in the second quarter of 2017 as compared with RMB 33 million in the comparable period in 2016. The [increase] (corrected by company after the call) was mainly driven by a increase in research staff for our core data center business.

Our adjusted EBITDA decreased -- increased to RMB 109 million compared with the RMB 15 million in the prior year period, RMB 100 million in the first quarter of 2017. Adjusted EBITDA margin increased to 12.4% compared with 1.7% in the prior year period and 11.6% in the first quarter of 2017. If we exclude bad debt provisions from our adjusted EBITDA, our adjusted EBITDA margin is 14.2% compared with 6.6% in the prior year period and 13.4% in the first quarter of 2017.

Adjusted EBITDA for our hosting and related services was RMB 171 million compared with RMB 108 million in the prior year period, RMB 153 million in the first quarter of 2017.

Adjusted EBITDA for our MNS business was negative RMB 63 million compared with a negative RMB 93 million in the prior year period, a negative RMB 52 million in the first quarter of 2017.

Adjusted net loss narrowed by 28.1% to RMB 84 million compared with RMB 116 million in the prior year period. Adjusted net margin in the second quarter of 2017 improved to negative 9.5% compared with negative 12.8% in the prior year period.

Adjusted diluted loss per share for the second quarter of 2017 was [RMB 0.13] (corrected by company after the call) which represents equivalent of [RMB 0.78] (corrected by company after the call) per ADS.

As of June 30, 2017, our cash and cash equivalents and the short-term investment were RMB 758 million, equivalent to USD 112 million.

Now let me provide you with our guidance for the third quarter of 2017. We expect our net revenues to be in a range of RMB 860 million to RMB 900 million compared with RMB 968 million in the prior year period. Adjusted EBITDA is expected to be in a range of RMB 108 million to RMB 122 million compared with RMB 68 million in the prior year period.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question is from Yang Liu from Morgan Stanley.

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

I have 2 questions here. First is about MRR. Could you please share some update on the MRR? We are glad to see that MRR start to stabilize sequentially and the Hosting MRR increased sequentially. Now what is the reason behind that cost increase? Is it due to location mix or better competition? And how about the future outlook? The second question is on the guidance. For the third quarter revenue guidance, could you please share more color on the divergence trend of hosting as the revenue guidance looks flattish quarter-on-quarter? And in terms of the full year guidance, given the current run rate, I see some downside to revenue guidance but upside to EBITDA guidance. Will management revise the full year guidance?

Zhenqing Zhang ***21Vianet Group, Inc. - CEO & Director***

I will take the first MRR question, and [Terry] will walk you through the guidance. As you mentioned, the MRR for our hosting business, which is about the revenue we generate for our data center cabinets is roughly, in the second quarter, about RMB 7,697 compared with RMB 7,746 in the previous year period and RMB 7,598 in the first quarter. The MRR for our hosting business has been relatively stable for the past 6 quarters. So it means we see a stable environment for the data center business. And going forward, and we will forecast roughly the same kind of stable MRR for the hosting business. Terry, you want to talk about guidance?

Shilian Wang ***21Vianet Group, Inc. - CFO***

Okay. Thank you. Yang, yes. I think that the guidance we gave to the third quarter, the guidance -- and if you look at the second quarter and the third quarter, relative flat. But I actually want to point out even for the flatter guidance, but you can see our achievement in the second quarter and versus the third quarter, two things I want to say. One is the revenue side. As our MNS business decline from topline and even with the same guidance and revenue range, but our hosting continues to grow. So our core business revenue take a larger portion of the revenue pot. Second point I want to make, the guidance for EBITDA. The EBITDA, you can see or we see the quarter-over-quarter improvement from first quarter and second quarter. And third quarter, our guidance pretty confident that we -- a lower range is higher than our achieved in this second quarter. So as a result and answer the question you asked about the whole year guidance, I think we're pretty confident that we can meet our whole year guidance. We don't have any expectation to revise our new guidance -- whole year guidance at this point.

Operator

(Operator Instructions) We have a question from Stella Li from Citi.

Stella Li

I have 3 questions. The first one is about our MNS business. Just wonder, if we have a guidance about when this business roughly may no longer continue to negatively affecting our revenue and EBITDA. The second question is about margins. We see there are improvement in our both gross profit and also EBITDA margin. Just wonder how much more room there is that we can continue to increase this margin? The third question is about CapEx. Roughly, what's our CapEx expectation for third quarter and fourth quarter? And what area are we going to spend the money?

Zhenqing Zhang ***21Vianet Group, Inc. - CEO & Director***

For the MNS business, as we stated, we are evaluating all the strategic options. And, of course, it's our intention we want to find out some sort of solution to this as quickly as possible. And it's our expectation, definitely, we'll find a solution in the next 3 to 6 months. For the margin improvement, the margin improvement was driven for our data center co-location business. It was driven by both revenue growth and our internal optimization on all the costing structure. For revenue growth, it was driven by both new customers and also the expansion of our existing customers. Like I mentioned that in the third quarter, we secured our contract with China Payment Clearing Association that's mainly for payment clearing and settlement for third party like Alipay and WeChat Pay settlement. We also got expansion contracts from [BB] and (inaudible) in the second quarter. We also have signed contracts with a lot of small- to medium-sized Internet companies in the gaming industry, in the big data industry. Another driver for our margin improvement in our [call] business is internal cost optimization. As we mentioned, we have reduced our inventory by close to 500 cabinets in the second quarter. Those inventory were mainly partnered cabinets because we are shifting more and more our customers' contracts and others into our self-built data centers, which have a higher margin versus the [partner] data centers. We are also implementing measures to internally optimize our utility usage to improve the efficiency in the operation of our data center. All those measures are driving margin improvement.

Going forward, we see this trend will continue to drive both revenue growth and internal cost optimization. So the Managed Network Service business, we are -- with the rapid decline of revenue, we are taking a lot of measures to renegotiate our bandwidth contracts to cut down the cost. So we will see continued improvement and the stabilization in the margin for our network business. I think, for CapEx, looking forward in the third quarter and the fourth quarter is roughly about RMB 100 million per quarter going forward, and those are mainly for our new data center buildup.

Shilian Wang ***21Vianet Group, Inc. - CFO***

Let me add one thing, that we have a joint venture with Warburg Pincus. So the company's strategy and -- to move to the sort of a tendency to assets-light the heavy investment for the land and [building] that we have the joint venture to build for us. So going forward, our CapEx and we look at the beginning of the year, we gave to The Street. So this year, the CapEx will be slower, will be smaller than what we give to The Street and -- beginning of the year because of the strategy we changed to take and the assets-light approach.

Stella Li

Okay. Is there a number guidance [on roughly] what's the CapEx side?

Shilian Wang ***21Vianet Group, Inc. - CFO***

Yes, CapEx guidance -- and the beginning of the year, we gave The Street that's about RMB 600 million. But this year, actually at this point, as Steve mentioned and going forward next couple of quarters and RMB 100 million a quarter roughly. So this year, approximately about RMB 400 million CapEx. So that will be lower than what we gave out at the beginning of the year.

Stella Li

I see. Just a follow-up question on our joint venture with Warburg Pincus. You mentioned that the JV will be responsible for building the data centers and hence, there will be lower CapEx by our side. But for them, at the JV level when they are spending those CapEx and then when the JV incur additional debt or liability, do we provide certain guarantee for those kind of debts?

Zhenqing Zhang ***21Vianet Group, Inc. - CEO & Director***

No. Because the JV is, in our opinion, is well funded. You will have about RMB 1.2 billion equity, and I think the JV is roughly 50-50 split between us and Warburg Pincus. I think it has the necessary financing for all the new data center buildup going forward.

Stella Li

Okay. So the JV will be responsible for their own fundings, and we don't expect to provide any funding assistance (inaudible) for them?

Zhenqing Zhang ***21Vianet Group, Inc. - CEO & Director***

Yes.

Operator

(Operator Instructions) We don't have any questions as of the moment. Please continue.

Zhenqing Zhang ***21Vianet Group, Inc. - CEO & Director***

Once again, thank you all for joining us today. Please don't hesitate to contact us if you have any further questions. We look forward to talking with you in the coming quarters. Thank you.

Shilian Wang ***21Vianet Group, Inc. - CFO***

Thank you.

Operator

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