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CONFERENCE CALL PARTICIPANS

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Tina Hou *Goldman Sachs - Analyst*
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PRESENTATION

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

Before we begin I will read the Safe Harbor Statement. This call may contain certain 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.

They 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 will now turn the call over to Mr. Steve Zhang. Please proceed, sir.

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

Firstly, we are pleased to announce another solid quarter of healthy growth in our core business. 21Vianet continues to evolve as China's transforming internet-infrastructure industry, as we see the continued rapid adoption of cloud solutions, increasing specialization of service, as well as healthy demand for co-location services from internet companies demanding expanded data applications, as well as a variety of other industries including financial institutions, which are seeking additional services like disaster recovery within our data centers.

As more new cloud-based services emerge, like artificial intelligence, internet of things, blockchain and big data, we believe the growing potential from -- for computing capacity and the storage, as well as internet traffic, will grow exponentially in China.

To strengthen the relationship in the IDC market we had set a plan to build an unparalleled digital real-estate platform aiming to add 80,000 to 100,000 new cabinets over the next five to seven years.

Let me start by talking in a bit more detail about our recent move to form our strategic joint venture with Warburg Pincus to build a digital real-estate platform in China. The data center industry as a whole is transforming quickly towards specializations. One side is a traditional retail co-location business. And the other side is the large-scale wholesale and customized data center business, like Digital Realty Trust's model.

These changes are the impetus behind several of our recent restructuring efforts and partnerships. Similar to the specialization we have seen in the US market, our strategy is to focus on asset-light business, which will be separated from the capital-intensive business.

Our partnership with Warburg Pincus not only brings in extensive network resources but also brings in their expertise in the real-estate industry. For 21Vianet, with our deep industry experience in data center operation, we see the separation of these two business as a solid strategic move which will benefit us with a significant reduction in CapEx for future build-outs and the tremendous growth opportunities, by more specifically focusing on both the wholesale data center and the retail market in China.

Next, I would like to talk about the progresses we achieved in our hosting-related business. For our core IDC business, we added over 2300 new cabinets in our self-build data centers during the quarter. The majority of the increase comes from our newest data center in Beijing, which opened towards the end of the third quarter.

Supported by solid growth in billable cabinets, our data center utilization rate continued to increase to 77.9%, despite these large additions. Our cloud business showed continuous strength in terms of revenue and the profitability. We recently launched the IBM Bluemix services for general availability in October to all China-based users, with added services like artificial intelligence and the blockchain.

CCTV.com was one of the early adopters of IBM Bluemix services. We have great expectations in this deepening partnership with IBM and believe it will facilitate a much wider range of cloud-related cooperation opportunities between the two companies and building a robust and comprehensive cloud ecosystem in China.

I also want to touch upon our hybrid-IT business strategy. Since we announced this strategy at the start of the year we have welcomed more and more new partners into our ecosystems, including two newly added customers. One is Aetna; one of the five largest health insurance providers in the US. And the other is Bupa, UK's leading healthcare specialist.

We provide a complete package of customized, secure and carrier neutral IT solutions to them, enabling them to provide stable and safe services to their customers. Such high-profile partners are able to rely upon 21Vianet's solution to help them achieve both flexibility and superior performance for their hybrid-IT needs.

I would also like to talk a bit about our interconnection platform. As you are aware, this platform is similar to the Equinix cloud-exchange model. We have been gradually rolling it out in our data center operations with several pilot projects.

Our interconnection platform enables our data center customers to achieve stable, secure and fast data transmissions within our data centers through interconnection technology, no matter where the data centers are located. It also allows for cloud exchange, which enables customers to establish more secure connections from their applications to the cloud, and the data exchange with internet service providers.

Our interconnection platform will significantly accelerate users' connections and reduce customers' bandwidth costs. We are so far very pleased with the progress of these pilot projects and hope we can soon roll out this high-margin offering to our data center customers.

For our CDN and MNS business we continued to experience ongoing challenges as a result of the combination of the market competition and the regulatory restrictions. We see some early signs of stabilization. And we are working diligently to streamline our cost structure, which will help us begin to grow with steady margins, as demand solidifies.

In summary, we are pleased with the strong performance in our core IDC business and the closing of our joint venture with Warburg Pincus. This helps position us more strategically in terms of scope of service offerings, world-class partnerships, financial resources, capital structure and the industrial expertise to capture this industry's solid, secular growth. And aim to become the number one player with the best in class data center facilities, serving both the wholesale and the retail co-location market in China, going forward.

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

Terry Wang: Thanks Steve. Let me start with our third quarter of 2016 financial results. Before I begin, I would like to state that we will present the 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 the reconciliation tables included in our press release. Also note that all the financial numbers we are presenting today are in RMB and percentage of change is year-over-year, unless otherwise stated.

We are very glad that the third quarter 2016 results came in above our initial guidance, both for net revenues and the EBITDA, driven by steady growth in our core businesses. We also began to see contribution from our core cost-structure optimization and operating efficiency improvement started from first half of the year, especially in the MNS and CDN businesses.

Our net revenues for the third quarter of 2016 increased by 4.8% to RMB968 million, primarily driven by the year-over-year growth in IDC, cloud and VPN revenues, partially offset by decline in the MNS revenues.

Net revenues from hosting and related services increased by 19% to RMB828 million in the third quarter of 2016, from RMB696 million in the prior year period, primarily due to the year-over-year increase in total number of billable cabinets and the improved utilization rate, partially offset by lower monthly recurring revenue per cabinet.

Our monthly recurring revenue per cabinet for the third quarter was RMB8,696, compared with RMB8,793 in the second quarter of 2016. The decrease in the monthly recurring revenue per cabinet was mainly attributable to continued bandwidth pricing pressure, as well as billable cabinets in certain markets with the lower market prices, which expected to be temporary.

Net revenues from the managed network services were RMB140 million in the third quarter of 2016, compared with RMB228 million in the prior year period. The decrease was primarily due to the continued industry-wide decline in the bandwidth prices and the intensified competition.

Adjusted gross profit was RMB225 million in the third quarter of 2016 compared with RMB241 million in the prior year period. Adjusted gross margin was 23% in the third quarter of 2016, compared with 26% in the prior-year period and 22% in the second quarter of 2016.

The year-over-year decrease in the gross margin was primarily due to continued softness in our MNS business.

Adjusted operating expenses were RMB294 million compared with RMB231 million in the prior year period. As a percentage of net revenues, adjusted operating expenses were 30% compared with 25% in the prior year period and 34% in the second quarter of 2016. More specifically, sales and marketing expenses were RMB100 million in the third quarter of 2016, compared to RMB89 million in the prior year period.

The increase was primarily due to the increase of labor cost and outsourcing cost, which were partially offset by decreased agency fee.

General and administrative expenses were RMB190 million in the third quarter of 2016, compared to RMB139 million in the prior year period. The increase was primarily due to increased staff cost and bad debt provision.

Research and development expenses were RMB36 million in the third quarter of 2016, relatively stable compared to RMB35 million in the prior year period. Changes in fair value of contingent purchase consideration payable was a gain of RMB12 million in the third quarter of 2016 compared with a loss of RMB0.7 million in the prior year period.

Our adjusted EBITDA for third quarter of 2016 was RMB68 million, compared with RMB122 million in the prior year period. Adjusted EBITDA margin for the third quarter of 2016 was 7% compare with 13.2% in the prior year period and 1.7% in the second quarter of 2016.

Adjusted EBITDA for the third quarter of 2016 excludes the share-based compensation expenses of RMB33 million, and the changes in fair value of contingent purchase consideration payable, which was a gain of RMB12 million.

Adjusted net loss for the third quarter of 2016 was RMB84 million, compared with adjusted net profit of RMB15 million in the prior period. Adjusted net margin in the third quarter of 2016 was a negative 8.7% compared with a net profit margin of 1.7% in the prior year period and a negative 12% in the second quarter of 2016.

Adjusted diluted loss per share for the third quarter of 2016 was RMB0.02, which represents the equivalent of RMB0.12 per ADS. As of September 30, 2016, our cash and cash equivalents and the short-term investment were RMB1.68 billion, the equivalent to $252 million.

Before I move on to financial guidance I would like to briefly discuss our bond redemption in August, to take advantage of the current low interest rate in the market. We have tendered about 79% of total bond with interest of 6.875%, due in June 2017, which is RMB1.5 billion in the principal amount. We lowered our interest rate from 6.875% level to below 5%, which will greatly lower our interest expenses.

Now, let me provide you with our guidance. For the fourth quarter of 2016 we expected our revenue to be in the range of RMB900 million to RMB940 million; adjusted EBITDA expected to be in the range of RMB50 million to RMB70 million. For the full year of 2016 the Company now expect the net revenues to be in the range of RMB3.64 billion to RMB3.68 billion, revised from prior guidance of RMB3.62 billion to RMB3.66 billion.

Adjusted EBITDA for the full year of 2016 expected to be a range of RMB242 million to RMB262 million, revised from prior guidance of RMB240 million to RMB260 million.

These forecasts reflect the Company's current and preliminary view which may be subject to change.

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

QUESTIONS AND ANSWERS

Operator: Thank you. (Operator Instructions). Our first question today comes from the line of Matthew Heinz from Stifel. Matthew, please go ahead.

Matthew Heinz: Hi. Good morning. Thanks for taking my questions.

Steve Zhang: Hi Matthew.

Matthew Heinz: One question on the cloud business. You briefly mentioned the IBM Bluemix launch. I just wondered if you could give us an update there in terms of total RMB in cloud revenue and split between IBM and Microsoft cloud products.

And then, secondarily, just a question on the interconnection platform pilot. I think from a few years back I recall that there were some regulatory barriers to essentially earning revenues from interconnection related products or selling cross-connects without the telecom license. And I'm just wondering if there's been any progress made on that. Or if the venture is purely based on a co-location product. Or will there be incremental revenue opportunities from cross-connects there?

Steve Zhang: First of all, let me first talk about the question related to the cloud. IBM Bluemix Cloud was only launched in October. Their dedicated version was launched in July this year. The dedicated version basically enables their customers to build their private cloud using Bluemix technology.

And the -- their public cloud was only launched in last month, October. So, their revenue is still relatively much smaller compared with Microsoft. And -- but we see some enterprise customers are showing great interest in the IBM offering.

Number two, talking about interconnection platform, we are seeing a lot of interest from our customers that they want to connect their applications which are hosted in our data center with the public clouds like Ali Cloud, Tencent Cloud, Microsoft Cloud, and when we talk about interconnection platform, we are mostly talking about interconnections with a lot of the public cloud services.

Matthew Heinz: Okay, I guess my question on the interconnect though, is there an opportunity to earn incremental revenue streams from selling cost-connects to both the providers and the enterprise customers that may come into the facilities to interact with those clouds?

Steve Zhang: Yes.

Matthew Heinz: Okay. And then just on the cloud business, are you still disclosing the revenue growth levels and overall sales levels in that business segment or is that something that you discontinue?

Steve Zhang: We don't do the segmented reporting specifically related to the cloud business.

Matthew Heinz: Okay, thank you.

Operator: (Operator Instructions). Our next question today comes from the line of Tina Hou from Goldman Sachs. Tina, please go ahead.

Tina Hou: Hi, good morning, management. Thanks for the call. I have two questions. The first one is, Steve, you previously mentioned that you have seen the competition in CDN and MNS space stabilizing recently. I was wondering if you could share more colors on that? What kind of instances have you seen in terms of the competition stabilizing?

And then the second one is that, Terry, you mentioned that the monthly recurring revenue per cabinet was down mainly due to the bandwidth -- the lower bandwidth prices. So, I was wondering, excluding the bandwidth prices what is the monthly recurring revenue per cabinet trend?

Thank you.

Steve Zhang: When we talked about the CDN and MNS business, first of all on the CDN side, the competition on pricing is still intense. For the MNS business, we are seeing the pricing stabilize because of the limited supply and also limited capability to meet the market demand.

On the cost side, we are seeing some stabilization.

Terry Wang: Okay, let me answer the second question regarding the MRR slightly decline quarter-over-quarter. I think, Tina, that the bandwidth pricing is the factor that dragged the pricing MRR decline. That is the fact. But if you exclude that effect, we will see regionally by each region, because the different region have a different cabinet revenue, cabinet basis, so we still see that the price is very stable. I mean, it's very stable, we don't see any trend that pricing declined over time just for the cabinet basis.

Tina Hou: Okay, thank you very much. And just a very quick follow up. So how much percentage of the MMR is bandwidth?

Terry Wang: Okay, we have, for example a different region have a different percentage but on a general basis, we have MRR for Beijing that reaches about RMB10,000 a month. So, within the RMB10,000 a month, it's approximately about between 25% to 30% is to come from the bandwidth sales.

Tina Hou: Great. Thank you very much. And then just one more follow up on the CDN side. So how much have you seen the CDN price declined this year so far?

Steve Zhang: About 20% to 30% drop.

Tina Hou: Okay, so 20% to 30%. And then on a regular basis, the drop is about 15% to 20% would you say?

Steve Zhang: Yes.

Tina Hou: Okay, thank you.

Operator: (Operator Instructions). Our next question today comes from the line of Yang Liu, from Morgan Stanley. Yang, please go ahead.

Yang Liu: Hi, management. Thanks for the opportunity to ask questions. I would like to ask the IDC pipeline in the fourth quarter, previously the management guidance this year, 21Vianet will deploy 3500 new data centers and now, we see pretty good progress up to the third quarter and could management share about the development of the fourth quarter data center new cabinet deployment? Thank you.

Steve Zhang: Yes, I think so far this year we have added over 3000 new cabinets. And in the fourth quarter, it's about 300 new cabinets and we have two major projects going on but these two projects probably will be delayed until the first quarter next year.

Yang Liu: Okay. And I see the CapEx so far in the third quarter is only RMB140 million something versus a guidance of RMB500 million CapEx, is that slightly lower than run rate CapEx due to the delay of the two projects?

Terry Wang: Partially, yes. And the new project will be delayed to the next couple of quarters. So, that was planned earlier.

Yang Liu: Okay, thank you.

Operator: Our next question today comes from the line of Matthew Heinz from Stifel. Matthew, please go ahead.

Matthew Heinz: Hi, thanks for the follow up. Just one on the guidance for the fourth quarter. Just would like to get some color on kind of what's driving the expected sequential decline in revenue. If that is primarily coming on the MNS side. Do you expect to see a sequential growth in the hosting business?

And then on the margins, it looks like the margin guidance is kind of flat sequentially. I believe you talked last quarter about potentially being done with the cost initiatives as we turn into next year and just would appreciate any color you could add on when you expect to see some lift in the EBITDA margins.

Terry Wang: Okay, this is Terry.

On the revenue side, you see the guidance a little bit below than there are the third quarter's actual revenue. The reason for that is the -- we haven't separated the two business. One is the hosting area, we continue to see the strong growth and that is the stabilized growth, but the things that drag us down is still the MNS area, which is challenged by the pricing continue to fall, decline, and competitions on the CDN side and also the -- on the Aipu, our residential Wi-Fi service area, 2C area has been compete -- tremendous pressure by the China Mobile launch, their strategy to get -- they targeted to get the customers' promotion pricing, by pricing these cuts.

So, we have to be careful on that. So, on that point of view, we have to be cautious about giving the guidance.

For the margin and EBITDA position, I think that is flat given that the revenue were a little bit lower than the third quarter. I think that our total amount of EBITDA actually, if we are talking percentage wise, will actually -- gone up a little bit. In other words, that we have been initiating some of the cost control improvements and related to our procurement of our supplier on the bandwidth side, and also efficiency of operation in our cabinet reduced our inventory on the cabinets and also the increase our -- the usage of the bandwidth that we purchase to be merged with demand.

So, that give us some of the confidence that we can improve our margin a little bit. I think that this target for next year, when you ask the next year's trend, I think that next year is going to be good for us that we have the measures we're taking for the efficiency running operation by cutting the cost and reduce some of the expenses. I think the margin will be going up next year, as we pointed out earlier. We will be reaching the double-digit and no question about it.

Matthew Heinz: Okay, thank you very much.

Steve Zhang: Thank you.

Operator: (Operator Instructions). As there are no further questions on the line at this time, that does conclude today's conference. We thank you all for your participation, you may now disconnect.