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PRESENTATION

Operator

Hello, ladies and gentlemen. Thank you for standing by for the Second Quarter 2023 Earnings Conference Call for VNET Group, Inc. (Operator Instructions) Participants from our management include Mr. Jeff Dong, Chief Executive Officer; Mr. Qiyu Wang, Chief Financial Officer; Mr. Tim Chen, Chief Strategy Officer; and Ms. Xinyuan Liu, Investor Relations Director of the Company. Please note that today's conference call is being recorded. I will now turn the call over to the first speaker today, Ms. Xinyuan Liu. Please go ahead.

Xinyuan Liu ***VNET Group, Inc. - Director of IR***

Thank you, operator. Hello, everyone, and welcome to our second quarter 2023 earnings conference call. Our earnings release was distributed earlier today, and you can find a copy on our IR website, as well as on newswire services.

Please note that the discussion today will contain forward-looking statements made under the Safe Harbor provisions of the U.S. Private Securities Litigation Reform Act of 1995. Forward-looking statements are subject to risks and uncertainties that may cause actual results to differ materially from our current expectations. For detailed discussions of these risks and uncertainties, please refer to our latest annual report and other documents filed with the SEC. VNET does not undertake any obligations to update any forward-looking statements, except as required under applicable laws.

Please also note that VNET's earnings press release and this conference call include the disclosure of unaudited GAAP financial measures as well as unaudited non-GAAP financial measures. VNET's earnings press release contains a reconciliation of the unaudited non-GAAP measures to the unaudited GAAP measures. As a reminder, this conference is being recorded. In addition, a webcast of this conference call will also be available on our IR website at ir.vnet.com. I will now turn the call over to our CEO, Jeff.

Jeff Dong ***VNET Group, Inc. - CEO***

Thank you, Xinyuan. Good morning, and good evening, everyone. Thank you for joining our call today. I will start with an overview of our second quarter results. After that, I will turn the call over to Tim, our CSO, and Qiyu, our CFO, who will discuss our financial results and outlook in more detail.

We are pleased to report a solid second quarter with utilized cabinets growing by 2,000 and overall utilization rate further improving to 59%. Total cabinets under management reached approximately 86,900 by the end of the quarter compared with approximately 80,800 one year ago. Our retail MRR per cabinet continued climbing to reach a new high at RMB 9,530 during the quarter. As we maintained our focus on high-quality revenue business to drive higher margin and better profitability, we achieved second quarter revenue of RMB 1.82 billion, representing an increase of 5.6% year over year and adjusted EBITDA of RMB 535 million, an increase of 9.9% year over year. Our solid operational and financial performance reaffirms our ability to quickly capture incremental market demand for high-quality, scalable IDC services amid the steady economic recovery.

It is very clear that the digital economy is becoming an increasingly important driver of China's overall economic development. To accelerate the post-pandemic recovery and boost growth, China's policymakers are stepping up supportive policies to strengthen the digital economy and upgrade industries with cutting-edge technologies such as big data, AI and 5G. Recently, new AI application scenarios are emerging across different industries in China, unlocking more demand for IDC services as training and optimizing AI models require massive computing power.

I'm proud to share the good news, VNET was selected as a computing power partner in the Generative AI Innovation Partnership Program set up by the Beijing municipal government in July. This government-backed program aims to build synergies across Beijing's generative AI industry value chain, supporting AIGC companies with high-performance and highly scalable computing power and fueling the development of foundation models. Our inclusion in this program once again showcases our outstanding track record, strong computing power resources and service capabilities. We expect to tap into more AI-driven demand in the near future.

Now let's take a closer look at our second quarter business updates. First, I'd like to share some exciting early signs of growing demand from generative AI for our business. Dozens of Large Language Models have already been launched across different sectors this year, although many of them are still in the training stage. General models are dominated by internet giants, while vertical models are being built by leading players in specific industries, as well as some tech startups. Of the three fundamental elements for developing AI - that is, computing power, algorithms and data - computing power plays the most critical role for Chinese companies in effectively training their AI models, as many companies have already developed advanced algorithms and vast datasets.

Our wholesale data centers are able to offer high power density cabinets up to 40 kilowatts per cabinet, well capable of powering large language model trainings and deployments for internet platform operators. Our retail cabinets also have sufficient capacity for high performance computing deployments, offering over 30 kilowatts in a single cabinet. Generative AI demand is already arising from our existing customers across a variety of industries such as local services, healthcare and virtual reality. As demand expands further for data processing and storage requirements stemming from the AI boom, we are confident that our expertise in high-performance data center design, coupled with our extensive resources and execution capabilities, will enable us to ride the next wave of IDC services growth.

Next, moving to our wholesale business, which continues to build robust sales momentum. Recently, we won an extended contract for 45 megawatts of additional capacity from an existing internet giant customer. Our compelling value proposition, broad industry expertise, in-depth resource capabilities and strong execution skills assure the appeal of our wholesale service offerings to internet giants.

Turning to our retail business, where we continued to make meaningful progress expanding and diversifying our customer base. Our new customer wins were primarily attributable to digital demand from the IT services, manufacturing, and financial services sectors. Also, our scalable, high-quality IDC services continued to secure incremental demand from existing customers across various industries, including local services, financial services, online gaming, VR technology, manufacturing and mobility. Notably, in the second quarter, we extended our contract for 7 megawatts with an existing retail customer, which is a leading player in the local service sector.

Our innovative value-added services and customized solutions also continue to provide solid support to our retail business, especially in meeting the emerging demand for generative AI deployment. In the second quarter, we unveiled a new full-stack Bare-Metal-As-a-Service solution to support the significant computing power required by foundation models in generative AI. This new solution encompasses data storage, bare metal and direct cloud connect services, facilitating private and secure connections between customers and multiple cloud providers.

During the quarter, we signed a contract with a pioneering metaverse company in China for our one-stop, full-stack IDC services featuring this new solution. This comprehensive set of services will help the customer quickly acquire IDC resources at business peaks to meet its on-demand computing needs, while supporting its large model training to better expand its metaverse business with a low-latency, high-fidelity and immersive user experience. Going forward, leveraging our extensive IDC resources, large customer base and high-quality services, we'll advance this solution to serve a broader range of industries, seizing new opportunities arising in the AI space.

Next, I want to share an update on the Blue Cloud business. During the second quarter, we won a new multinational corporation, or MNC, customer, Moog Inc, a worldwide designer, manufacturer, and integrator of precision control components and systems. We'll provide Moog with the deployment and implementation services for its hybrid cloud infrastructure. Specifically, we will support the customer in building a new IT environment for its business development and operations in China, deploying localized IT infrastructure and implementing data migration to China-based cloud computing platforms to ensure its business continuity. We have built a wealth of experience and practical knowledge in this field by helping many MNCs land their business alongside IT infrastructure in China. The successful implementation of Moog's project will further strengthen our ability to tap into the increasing demand from multinational customers for IT environment localization and cloud migrations to merge with Chinese business systems.

On the ESG performance front, we are honored to be selected for inclusion in S&P Global's first China edition of The Sustainability Yearbook 2023, published in late June S&P Global evaluated nearly 1,600 Chinese companies across 60 industries through its 2022 Corporate Sustainability Assessment and ultimately recognized 88 companies for its Yearbook. VNET earned the highest ESG score among Chinese IT services companies participating in the assessment, a clear reflection of our industry-leading practices and achievements in ESG. As we forge ahead with our sustainability action plans, we will continue to innovate and implement strategies and initiatives that make a real difference, positioning VNET as a sustainability leader in the IDC services industry.

To summarize, our ongoing progress across each of our business lines, the increasingly favorable policy landscape and AI's growing prevalence are reinforcing our confidence in the mid- and long-term growth prospects of China's IDC services industry. With our reliable and scalable IDC services, high power density deployment capabilities, and loyal and expanding customer base, we are well positioned to maximize our dual-core business strategy to serve the digital demand driven by widespread digital transformation and the AI boom.

Thank you, everyone. I will now turn the call over to Tim and Qiyu to discuss our financial performance for this quarter.

Tim Chen ***VNET Group, Inc. - CSO***

Thank you very much, Jeff. Good morning, and good evening, everyone. Before we start the detailed discussion of our financials, please note that we will present non-GAAP measures today. Our non-GAAP measure results exclude certain non-cash expenses, which are not part of our core operations. The details of these expenses may be found in the reconciliation tables included in our earnings press release. Please also note that, unless otherwise stated, all the financials we present today are for the second quarter of 2023, and in Renminbi terms. Now, let me walk you through our second quarter financial results. Unless otherwise specified, the growth rates I will be reviewing are all on a year-over-year basis.

We remained dedicated to advancing high-quality revenue business to drive margin and profitability improvements. In the second quarter, our net revenues increased by 5.6% to RMB 1.82 billion from the same period last year, mainly driven by the continued growth of our IDC business as well as our cloud and VPN services. Gross profit was RMB 342.7 million in the second quarter of 2023, representing a decrease of 4.2% from the same period of 2022. Gross margin was 18.8% in the second quarter of 2023 compared to 20.7% in the same period of 2022.

Adjusted cash gross profit, which excludes depreciation, amortization and share-based compensation expenses, was RMB 742.9 million in the second quarter of 2023, an increase of 4.1% from the same period of 2022. Adjusted cash gross margin in the second quarter of 2023 was 40.8%, compared to 41.4% in the same period of 2022.

Adjusted operating expenses, which exclude share-based compensation expenses and compensation for postcombination employment in an acquisition, were RMB 241.5 million in the second quarter of 2023 and compared to RMB 250.7 million in the same period of 2022. As a percentage of net revenues, adjusted operating expenses in the second quarter of 2023 were 13.3%, compared to 14.5% in the same period of 2022.

Adjusted EBITDA in the second quarter of 2023 was RMB 535 million, representing an increase of 9.9% from the same period of 2022. Adjusted EBITDA in the second quarter of 2023 excluded share-based compensation expenses of RMB 8 million. Adjusted EBITDA margin was 29.4% in the second quarter of 2023, compared to 28.2% in the same period of 2022.

Our net loss attributable to VNET Group, Inc. in the second quarter of 2023 was RMB 232.9 million, compared to a net loss of RMB 377.2 million in the same period of 2022.

Basic and diluted loss were both RMB 0.26 per ordinary share and both RMB 1.56 per ADS. Each ADS represents 6 Class A ordinary shares.

Turning to our balance sheet. As of June 30, 2023, the aggregate amount of the Company's cash, cash equivalents and restricted cash and short-term investments was RMB 2.76 billion. Meanwhile, net cash generated from operating activities in the second quarter of 2023 was RMB 423.5 million, compared to RMB 942.7 million in the same period of 2022.

Our Capex in the second quarter of 2023 was RMB 405 million.

Finally, I want to thank you all and our team for all the support and partnership over the past couple of years. I'm thrilled to continue working with the Company's executive team on strategic initiatives, and I'd like to now turn it over to Qiyu.

Qiyu Wang ***VNET Group, Inc. - CFO***

Thanks, Tim. Thanks, Jeff. It's an honor to be part of VNET's leadership team. I look forward to leveraging my 20 years of industry experience and working with our team to drive our dual-core strategy and unlock more growth potentials.

In terms of our outlook, we currently maintain our full-year 2023 guidance and expect net revenues to be in the range of RMB 7,600 million to RMB 7,900 million, representing a year-over-year increase of 7.6% to 11.8%, and adjusted EBITDA to be in the range of RMB 2,025 million to RMB 2,125 million, representing a year-over-year increase of 8.1% to 13.5%.

Looking forward, we will continue to focus on high-quality revenue business to drive margin and profitability improvements. In addition, we will explore new opportunities arising from robust digital demand, especially AI-driven demand, and further strengthen our position as a leading IDC player. Our proven dual-core growth strategy, highly scalable service offerings and solid financial and operational results give us confidence in our prospects to deliver sustainable value to our stakeholders.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question will come from the line of Yang Liu from Morgan Stanley.

Pamela Huang ***Morgan Stanley, Research Division - Research Analyst***

This is Pamela from Yang's team. So I think recently, the most asked question is regarding company's plan to repay the convertible bond. So I'd just like to get some more financial comments on this, thank you.

Tim Chen ***VNET Group, Inc. - CSO***

Thanks a lot, Pamela. This is Tim here. As we've mentioned to the market before, we've been actively reaching out to multiple financing channels to the market. I think you're aware of our efforts in terms of the C-REITs, asset disposals, both public bonds and private placements. Also, I'd like to point out we have a relatively healthy cash balance of over RMB 2 billion of unrestricted cash. Obviously, with the shift to the management team, we're able to bring a larger focus also on to some of our onshore and our Renminbi financing channels with the addition of Qiyu to the senior team. So all of that is part of our overall efforts.

At the moment, we are still closely monitoring the bond markets in the U.S. Obviously, they are volatile, but all of our preparation work is completed. So we will wait for the next market window on that site but continue our efforts on all the other areas.

Operator

And our next question will come from the line of Edison Lee from Jefferies.

Edison Lee ***Jefferies LLC, Research Division - Equity Analyst***

First of all, congratulations on another big wholesale order. So maybe the first question is about that wholesale order. Can we talk a little bit about the timeline of the delivery? And then also the terms, are they somewhat similar to the previous order? And then can you remind me for the 3,000 cabinets that you're building on that side, what megawatt that is equivalent to? So my first question is about that.

Number two is on your operating cost. It seems that second quarter is a lot lower on a year-on-year basis. It's about 22% lower on a year-on-year basis. Can you share your outlook on operating cost for the second half of this year?

Jeff Dong ***VNET Group, Inc. - CEO***

I'll take the first question on our contract. I've mentioned in the call, we recently actually, we won extended contracts for 45-megawatts as additional capacity from existing internet giant customer. The contract has already signed actually to attach with previously announced in total 160 megawatts together to be fulfilled in different phases.

Let me elaborate a little bit more in details on this contract. We divide into different phases. In the first phase, a couple of buildings will be delivered highly possible by the end of the year and the second will be the half of next year. So the move-in will be very fast. So that's something we can share with you.

Edison Lee ***Jefferies LLC, Research Division - Equity Analyst***

Sorry, can I just follow up by asking, you indicated that this year you would deliver 3,000 cabinets on that side. So what is the equivalent megawatt for that 3,000 cabinets?

Jeff Dong ***VNET Group, Inc. - CEO***

Yes, correct. So we will deliver 3,000 by the end of the year.

Edison Lee ***Jefferies LLC, Research Division - Equity Analyst***

And what is the megawatt equivalent with that 3,000 cabinet?

Jeff Dong ***VNET Group, Inc. - CEO***

It's about less than 100 megawatts.

Operator

And our next question will come from the line of Sara Wang from UBS.

Sara Wang ***UBS Investment Bank, Research Division - China Telecom and Equipment Analyst***

Yes. So may I ask if there's any change to the Capex guidance for this year?

Tim Chen ***VNET Group, Inc. - CSO***

Sara, thanks for the question. In terms of Capex guidance, at the moment, there are no further adjustments in terms of the Capex guidance. Obviously, we are very much focused on the Capex for delivery of this year's cabinets. And where we can cut back, we actually have been scaling some of that activity back just given the fact that we want to build up a healthy cash reserve also for our upcoming CB refinancing. And the good news on the Capex front also is that although we are focused on the delivery of this year's cabinets, we also have a number of very, very strong project financing associated with those projects. And so overall, we expect that the cash impact should be more manageable from the activity that we have in terms of completing those cabinets for our 2023 deliveries.

Operator

And our next question will come from the line of Timothy Zhao from Goldman Sachs.

Timothy Zhao ***Goldman Sachs Group, Inc., Research Division - Research Analyst***

My question is regarding the EBITDA. Just wondering -- compared to your full year guidance, the low end and high end. Just wondering what are the key variables that you are thinking for the second half of this year in order for the company to achieve the midpoint or the high-end. And, also any color into the EBITDA margin into the second half, including any like a trend that you see from the tariff power -- tariff, power cost, et cetera, that would be very helpful.

Tim Chen ***VNET Group, Inc. - CSO***

Timothy, let me take this question here. Look, good question on the EBITDA margins. Obviously, for both first and second quarter, we've been working very hard on the cost control side. And so that's actually helped. There are a few, I would say, one-offs on the positive side both in first and second quarter, which we've shared with the market. That will not be repeated in the third and fourth quarters. So we do expect there to be, I guess, a reversion in terms of third quarter.

Some of the bigger factors that have impacted in second quarter and expect it to continue to impact in the third quarter relates to power and tariff costs. The average unit cost actually has been relatively stable in the second quarter. However -- and this is not unlike our peers in China right now. There is now a seasonality in terms of the summer months, where we do expect the utility cost to be higher. Also, as you can see from our figures in the PPT, we've had some substantial ramp-up in terms of customers moving into our data centers. And obviously, that also increases our overall utility costs.

Last but not least, in terms of an outlook, I would say that at moment, our guidance for the full year EBITDA remains unchanged. There is, I guess, an element of uncertainty around, let's say, second half power costs. There is an NDRC notification about provincial electricity transmission distribution prices during the third regulatory period. So we expect that, that will inject another layer of uncertainty, I would say, around power.

And I think for third quarter at the moment, we're probably expecting that EBITDA margins will contract a bit as compared to second quarter as some of these one-offs will disappear from the second quarter. But if the power costs remain stable, then we expect that third into fourth quarter, fourth quarter will then have an improvement in margins, obviously, given the cooler weather of the winter months.

Operator

That's all the time we have for Q&A today. And with that, ladies and gentlemen, that concludes our conference for today, thank you for participating. You may now disconnect. Everyone, have a good day.