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GDS.O - Q3 2017 GDS Holdings Ltd Earnings Call

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PRESENTATION

Operator

(Operator Instructions) Hello, ladies and gentlemen, thank you for standing by for GDS Holdings Limited Third Quarter '17 Earnings Conference Call. (Operator Instructions) Today's conference call is being recorded.

I will now turn the call over to your host, Ms. Laura Chen, Head of Investor Relations for the company. Please go ahead, Laura.

Laura Chen

Hello, everyone, and welcome to the 3Q '17 Earnings Conference Call of GDS Holdings Limited. The company's results were issued via Newswire services earlier today and are posted online. A summary presentation, which we will refer to during this conference call, can be viewed and downloaded from our IR website at investors.gds-services.com.

Leading today's call is Mr. William Huang, GDS Founder, Chairman and CEO, who will provide an overview of our business strategy and performance; Mr. Dan Newman, GDS CFO, will then review the financial and operating results.

Before we continue, please note that today's discussion 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 involve inherent risks and uncertainties. As such, the company's results may be materially different from the views expressed today. Further information regarding these and other risks and uncertainties is included in the Company's prospectus as filed with the U.S. Securities and Exchange Commission. The company does not assume any obligation to update any forward-looking statements, except as required under applicable law. Please also note that GDS earnings press release and this conference call include discussions of unaudited GAAP financial information as well as unaudited non-GAAP financial measures. GDS press release contains a reconciliation of the unaudited non-GAAP measures to the unaudited most directly comparable GAAP measures.

I will now turn the call over to GDS Founder, Chairman and Chief Executive Officer, William Huang. Please go ahead, William.

William Wei Huang - *GDS Holdings Limited - Chairman and CEO*

Thank you Laura. Hello everyone, thank you for joining today's call.

A few days ago we just celebrated 1-year anniversary of our IPO on NASDAQ. I am pleased to say that over the past year we have delivered everything that we said we will and more. I'm also pleased for all our shareholders to see that our share price is now trading well above the IPO price. In Q3 '17 we continued to make significant progress across all aspect of our business and have further strengthened our market leadership position.

Let's see this Slide 4. I will give you some financial highlights. We grew service revenue by over 58% year-on-year driven by 47% increase in total area utilized over the period. Delivery of the backlog accelerated in Q3 with addition of over 8,000 square meter of revenue generating space, by far our highest addition in a single quarter. We realized further operating leverage with adjusted EBITDA growing by over 70% year-on-year and our adjusted EBITDA margin reaching 31.5% compared with 26.2% in the same period last year.

Please see Slide 5. We continued the sales growth momentum and at the same time we continued to add significantly to our customer contracts, signing up over 6,000 square meters net of new commitments in Q3.

As shown on Slide 5, our total area committed grew to over 82,000 square meters, 41% higher than 1 year ago. Over the first 3 quarters of this year we have added over 21,000 square meters net of new customer commitments with over $100 million in terms of annual recurring revenue when fully delivered. This sales achievement is ahead of our expectations at the beginning of this year. It reflects a booming market and the strengths of our strategy position, which has given us a consistently high win rate.

We have significant sales pipeline which we have converting in Q4. And with the addition of this new business, we expect to end the year well ahead of last year's achievement of $120 million of new booking. While we are growing at record rates, we have been able to maintain a stable average selling price and we expect to achieve returns on new investment in line with historical levels.

We are also successfully renewing contracts each quarter with industry high retention rates. Churn was again only 0.1% in Q3. This reflects our high operating standards and a high degree of customer satisfaction. Pricing renewals is general at similar level to previous contracts.

Let's move to Slide 6. We continue to develop our customer franchise along 2 tracks. On one side, hyper-scale cloud and data intensive large Internet customers, and on the other side high demanding large private sector enterprise and FSI customers. We continue to work more and more close with our hyper-scale cloud and large Internet customers.

From our observation their demand for datacenter capacity (inaudible) is growing at even faster rates than expected. In the third quarter of 2017 our top 2 customers placed a new orders with us further increasing their total contract area in our datacenters.

Another existing cloud customer, one of the largest cloud service providers globally also expanded their deployment in one of our datacenters in the third quarter. In the fourth quarter of 2017 we expect to start hosting Baidu's cloud platform in addition to their traditional search business.

In September, we announced that we had received a telecom license which enabled us to provide a cloud connect service within and between our datacenters. By having multiple cloud service providers inside our datacenters including all the largest IaaS platform, we are able to capitalize on this opportunity to attract more enterprise and FSI customers.

During the third quarter of 2017 we increased our customer count by 9% to 496 customers at the quarter end. Notable name customers including a leading international luxury auto company, a multinational furnishing company, the national foreign exchange trading system et cetera. This significant increase in our customer base was largely driven by the availability of cloud connect service inside our datacenters.

Currently, we have over 30 cloud connect customers. During the computing conference hosted by Alibaba in Hangzhou a few weeks ago, Alibaba launched a hybrid cloud product together with GDS, which seamlessly integrated their public cloud (inaudible) resource with GDS colocation managed service and the cloud connect to provide the customer a total solution for their IT deployment. We have also entered into a partnership agreement with Microsoft to provide a direct connectivity to their cloud POPs inside our datacenters. In the next few months we will enter into a similar agreement for direct connectivity with another major global cloud service provider, a new customer for GDS which is currently installing their cloud POPs in our datacenters in 2 (inaudible) markets.

With all the cloud POPs either already there or coming, our cloud connect service is up and running, and is becoming a major focus for our further strategy growth. In the near future we will have a grand slam (inaudible) of all the top tier cloud service provider in China accessible inside our datacenters. By developing such a unique ecosystem we are adding value to our cloud customers by facilitating their road to market as well as to our enterprise and FSI customers.

Let's move to Slide 8. In the third quarter of 2017, we brought our Beijing 2 datacenter into service. With this addition we had over 77,000 square meters of datacenter area in service at the quarter end with around 90% commitment rate.

As announced a few weeks ago we acquired a second datacenter in Guangzhou. That's called Guangzhou 2, which is next to our existing Guangzhou 1 datacenter. Guangzhou 2 is a fully committed and utilized by a larger Internet customer. The acquisition was just complete in 4Q. We have also started the construction of our new datacenter in Chengdu, Chengdu 2 Phase 1. We expect to secure, anchor customer commitment for this project very shortly.

At the end of the third quarter of 2017 our total area under construction was over 37,000 square meters. Around 35% of this capacity or 13,000 square meters was precommitted with legally binding agreement.

However, for the remaining 65%, or 24,000 square meters, we have a substantial sales pipeline and a larger part of this capacity is already in the contracting process.

Like I said, our customers plan to upscale their datacenter capacity significantly over the next few years, and are looking to us to fulfill their requirements on a continuous basis. The opportunity is ours to lose if we do not keep up with this demand.

We already secured significant resource pipeline (inaudible) in all key markets to support our growth for the next few years. Meanwhile, we are also accelerating our resource expansion plan.

We have initiated new project at a faster rate than previously expected, and also sped up our development timelines. We have stepped up our procurement efforts in securing more resource, including industrial buildings and the land for our organic capacity growth. At the same time we are pursuing opportunities for project acquisitions so as to supplement our organic growth.

So far our focus has been entirely on Tier 1 markets, and this will remain our core strategy. However, we are exploring opportunities to work selectively with our hyper-scale cloud customers to expand their datacenter footprints outside the Tier 1 markets. This is very strategic for future growth.

Let's move to Page 9. We were delighted to announce the recently -- the formation of our strategic partnership with CyrusOne; one of the leading datacenter providers in the U.S. We feel that there is a very good fit between our business in terms of vision for the industry, strategic positioning, customer focus and culture. Furthermore, we feel that this is -- this alignment creates a unique value proposition for our customers and positions us better to fulfill their future requirements.

Currently, GDS has -- have about 50 foreign customers which accounts for around 10% of our revenue. This is an important customer segment and we believe that there is a high potential for us to expand with CyrusOne's 1,000 plus customer base in the U.S.

Our hyper-scale cloud and the large Internet customers also talk to us about their plans for international expansion especially in the U.S. With our partnership with CyrusOne we are now able to deepen our dialogue with these customers at a time when their overseas requirements are becoming quite substantial.

Following the announcement of the deal CyrusOne and GDS have assigned several key executives and has started to have comprehensive conversation between the 2 teams in terms of sales, construction, design and other aspects of business where we can benefit each other. CyrusOne is doing a very good job in keeping their development cost at a low level compared to their U.S. peers, which is surely something that we can learn from them. At the same time our operations tools are (inaudible) inspiring to them.

To underpin the commercial agreement between the 2 parties we'll receive the $100 million equity investment from CyrusOne which we will use to further expand our capacity. They will have about 8% of our issued shares capital as well as a board seat (inaudible). The connected economic interested and the board presence brings the 2 of us closer together and provide us added motivation to make this a highly success collaboration.

With that I will now hand the call over to Dan for the financial and the operation review. Thank you.

Daniel Newman - *GDS Holdings Limited - CFO*

Thank you, William. (technical difficulty) (inaudible)

our P&L analysis for 3Q '17, but in order to better highlight the underlying trends I'll start with the version shown on Slide 12. On a GAAP basis, service revenue grew by 27.6% quarter-on-quarter to RMB 423 million in 3Q '17. On a non-GAAP basis underlying adjusted NOI grew by 29.6% quarter-on-quarter to RMB 201.5 million. And underlying adjusted EBITDA grew by 34.4% quarter-on-quarter to RMB 134.9 million. The underlying adjusted EBITDA margin was 1.6 percentage points higher at 31.9% in 3Q17 compared with 30.3% in 2Q17.

Turning to Slide 13. In 3Q17 there was an increase in area utilized of 8,109 square meters, which was the major factor driving higher revenue growth. This increase resulted from accelerated move-in by certain cloud customers at our Shanghai 3, Shenzhen 2 and Shenzhen 5 facilities. Plus the move-in which occurred at the newly in service Beijing 2 datacenter.

The average monthly service revenue or MSR per square meter was RMB 3,031 in 3Q '17 compared with RMB 2,750 in 2Q '17. The MSR increase was mainly due to our high addition to area utilized in 3Q '17 occurring early in the quarter, driving up the average. We expect MSR to be sustained at more normalized levels in the coming quarters.

On Slide 14 we show growth in NOI and EBITDA and margin development over the past 5 quarters. In 3Q '17 we achieved an underlying adjusted NOI margin of 47.6%, which was 0.7 percentage points higher than for 2Q '17.

To better understand NOI margin development you can look at the analysis on Slide 15. The pie chart on the left shows the breakdown of our total capacity in service and under construction by stage of development. At the end of 3Q '17 we had just over 34,000 square meters or 29.7% of our total capacity, which was stabilized.

This part of the portfolio was 96.9% committed and 92.7% utilized. Our self-developed stabilized datacenters have an NOI margin of around 60% in 3Q '17. At the same time we had over 43,000 square meters or 37.8% of our total capacity, which was in service and still ramping up. This part of the portfolio was 84.2% committed but only 43.2% utilized as customers are still moving in.

Naturally, these datacenters have not yet reached the optimum operating leverage, but based on the existing customer commitments we can say that they are certainly on the same path to the same end result.

In summary, as datacenters come into service it results in a drag on our margins, but over time as the proportion of stabilized datacenters increases the overall margin will improve.

On Slide 16 our SG&A excluding D&A and stock-based compensation showed an improvement at 15.9% of service revenue compared with 16.9% in 2Q '17. Taken together with the improvement at the operating level the underlying adjusted EBITDA margin improved by 1.6 percentage points to 31.9% in 3Q '17.

Turning to our investment activities, as shown on Slide 17 we paid CapEx of RMB 443.7 million in 3Q '17. Replacement CapEx accounted for 2% of total quarterly CapEx, compared with 3.8% in 2Q '17.

Our total area under construction was 37,478 square meters across 7 sites, out of which 47.9% will enter service in 4Q '17. We will also have 5,375 square meters from the GZ2 Guangzhou 2 acquisition added to our area in service in 4Q '17.

Now I'd like to update you on the progress of each project, which was under construction as of 3Q '17. Shenzhen 4 Phase 1 has come into service during 4Q '17. We already have customers moved in and significant demand in hand for this facility.

Shanghai 4 will come into service at the end of this year. The capacity is fully allocated to customers with 53.3% already contracted and the rest in progress. Beijing 3 is one of the projects which we accelerated and has already come into service ahead of schedule in 4Q '17 it is 100% committed to a major cloud service provider.

Shenzhen 5 Phase 1 entered service in late June, a full quarter ahead of schedule and is 100% committed and already 62.8% utilized. Shenzhen 5 Phase 2 is under construction and will enter service in 2018. Phase 2 is reserved for expansion by the anchor customer in Phase 1.

Shanghai 5 is a new project which we announced in July. We have significant demand from both FSI and cloud customers for this facility and we are considering the allocation to satisfy our customer requirements. Shanghai 6 is the first of 2 datacenters on our new campus in the Waigaoqiao Free Trade Zone. It is about 45% precommitted by China's leading online travel company as we announced previously. The building is under construction pursuant to a build-to-suit lease with a property partner and we will not incur CapEx until the shell (inaudible) is handed over to us in the second quarter of next year.

Chengdu 2 Phase 1 is an expansion project at our Chengdu Campus. Chengdu 1 is 99.6% committed with 2 major cloud customers in the datacenter. We initiated Chengdu 2 to fill their demand and expect to obtain precommitments shortly.

With regard to financing as shown on Slide 18, at the end of the quarter, our gross debt was RMB 5.9 billion and our net debt was RMB 4.8 billion. The ratio of net debt to last quarter analyzed adjusted EBITDA was 8.9x. Pro forma for the $100 million proceeds of the equity issuance to CyrusOne the ratio would be 7.7x.

We have a convertible bond outstanding, which was issued in December 2015 it is held by our strategic partner STT and by Ping An Insurance. The conversion price is $13.40 per ADR. With the rise of our share price the CB is currently in the money. We have an issuer's call which (inaudible) can be exercised if the closing price of GDS ADRs is above $16.75 for 10 consecutive trading days.

If this condition is met we intend exercising the call in order to save interest and deleverage. On a pro forma basis conversion of the CB will reduce our net debt to EBITDA multiple by a further 1.9x. Combining the CyrusOne proceeds and CB conversion our net debt to EBITDA multiple would be 5.8x on a pro forma basis.

During 3Q '17 we secured RMB 570 million of new debt facilities including RMB 318 million of refinancing of existing short-term facilities. Our blended financing cost was 7.4% in 3Q '17 compared with 6.9% in 2Q '17. Excluding the convertible bond the cost was 6.8% in 3Q '17 versus 6.1% for the prior quarter. The increased financing cost was due to refinancing costs.

Looking at the debt maturity chart on the right-hand side of this slide, out of RMB 1.17 billion shown as maturing in 2018 we have now completed over RMB 700 million refinancing extending the maturity of this debt, which will be reflected in our 4Q '17 disclosures. Prior to the investment by CyrusOne all the projects which we've disclosed as in service and under construction up to the end of 3Q '17 are fully funded in terms of equity and debt.

What I mean by "fully funded" is that we have sufficient cash on our balance sheet to fully capitalize these projects and have secured sufficient project finance to take these projects to completion and to deliver the entire backlog and more.

The proceeds from CyrusOne investment will enable us to capitalize new projects that we intend taking on and announcing over the next few quarters. Under our articles our directors may only issue up to 10% of our existing share capital in a single transaction or a series of transactions during the 12-month period without the prior approval of shareholders.

As we've used up most of this capacity with the issue to CyrusOne we will consider seeking shareholder approval in the near future to raise the ceiling for a period of time. This will enable us to retain flexibility for future share issuance including capital raising. We may consider various opportunities to raise capital through the equity and debt capital markets.

As shown on Slide 19, at the end of 3Q '17 our backlog stood at 32,271 square meters, worth around $155 million in terms of annual recurring revenue, which is equivalent to 60% of our last quarter annualized revenue. Delivery of this backlog provides high visibility for revenue growth.

Finally on Slide 20, at the beginning of this year we provided guidance for FY'17 revenue adjusted EBITDA on CapEx which we reaffirmed in our last earnings call. We now believe that based on the financials we reported in our current growth rate, we expect our full year performance to be above the midpoint of the range that we originally guided.

Accordingly, we are raising the low end of the previous range to the midpoint of the previous range, the high end remains unchanged. The revised guidance is now RMB 1,525 million to RMB 1,575 million for revenue and RMB 480 million to RMB 495 million for adjusted EBITDA.

The top end of the range implies year-on-year growth of 57% in service revenue and 83% in adjusted EBITDA. In order to meet strong demand as reflected in our sales achievement during the year-to-date we've initiated new project at a faster rate than previously expected and accelerated development timelines. Accordingly, we now expect CapEx for the year ending December 31, 2017 to reach about RMB 2.3 billion as compared with the previously provided level of around RMB 1.8 billion.

With that I will end the formal part of my presentation and we'd now like to open the call to questions. Operator?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) We have the first question from the line of Gokul Hariharan.

Gokul Hariharan - *JP Morgan Chase & Co, Research Division - Head of Taiwan Equity Research and Senior Tech Analyst*

Congrats on the great results William and Dan, and congrats on the CyrusOne deal also, I had a couple of questions, Dan, you did mention about the breakdown of the portfolio by development stage, could you give us some idea about where you expect the EBITDA margins for maybe the area in service and area in stabilized ones and area in service ramping up standard datacenters, roughly -- I don't think you want to give the exact numbers, but if you could give us some rough ranges on that? And the second question I had is, William did refer to some of the projects for a strategic reason looking at some of the non-Tier 1 locations, could you talk about what size this would account for eventually in terms of the overall area under service, is it going to be small, or is it going to be something that's quite big for some of your bigger cloud customers?

William Wei Huang - *GDS Holdings Limited - Chairman and CEO*

Dan, maybe you answer this first question?

Daniel Newman - *GDS Holdings Limited - CFO*

By the way this pie chart can be constructed from the data which is disclosed in the appendix's presentation. So if we look at the 2 parts of the pie which relate to datacenters and service, "stabilized" refers to datacenters where the utilization rate is above 80%, it happens, currently, to be 92.7%, for that part of the portfolio in aggregate. So that part of the portfolio is pretty close to reaching the highest level attainable in terms of margin. So we never refer to it as EBITDA margin, we refer it to as NOI margin. The NOI margin for that part of the portfolio is around 60%. For the part which is ramping up, it's the aggregate of datacenters at all sorts of different stages, some are EBITDA negative, and some are breakeven and some are on their way closer to reaching stabilization. If we add the red and the gold looking at this pie chart, we add the stabilized and the ramping-up together, the aggregate NOI margin for the area in service is 47%. So that gives you some idea of how much the ramping-up part is dragging down or averaging down the overall. But the area under construction, most of the costs, preoperating costs are capitalized. We do include in SG&A some start-up costs of a few million RMB and of course there are some other overheads related to new projects. But the area under construction doesn't impact the NOI margin. It only impacts the NOI margin as projects move from under construction to in service.

William Wei Huang - *GDS Holdings Limited - Chairman and CEO*

Number one, I think the global market trend has evolved. The whole market mainly driven by the hyper-scale, a cloud player and Internet giants, this is what happened in China already. So in China it's same, I see -- what we can tell is -- to echo this evolution I think the product (inaudible) difference. So we still -- as I said, we still keep the develops -- our focus on develop, our core datacenter in our all the key market, Tier 1 city, this is already -- I don't want to repeat it. To echo the market evolving, I say, we are -- we see some hyper-scale demand is in -- will happen in near future in Tier 2 city and to catch up with this another growth driver, GDS is well prepare to catch up with that. So I think that we can tell in the next couple of years the growth was 2 type of the growths, one is the high performance datacenter which as we already did in last 10 years, another new growth driver will come from the hyper-scale. We don't want to lose this opportunity. But so far we are quite selected to do in Tier 2 city. Our another strategy as I repeated in the last couple of quarters, I say we will not -- we are focused on our Tier 1 city, and we will focus on to follow up our key customer, which is a cloud player, and that therefore it will add GDS in the (inaudible) next few years still maintain the competitive advantage in strategic review. That's my answer. But if you look at -- currently -- let me give you some clear percentage of our business. I just want to say just as thoughts, it's not to say I cannot give you a certain number currently.

Operator

We have the next question from the line of Jonathan Atkin.

Jonathan Atkin - *RBC Capital Markets, LLC, Research Division - MD and Senior Analyst*

Thanks very much, so I was interested in the guidance change and how much of that reflects inorganic factors, I may've missed it, I think you may've called out the revenue contribution from Guangzhou 2, but if you could maybe just clarify how much of the guidance is organic versus -- organic? And then secondly in the scripts you spoke about obtaining additional resources, land would be an example of that, and can you talk a little bit about the different cities where you have land not yet under development, and therefore it would appear in any of the charts that you provided. You've talked about challenges in the Beijing market in prior calls, but if you could maybe give us a little bit of color around that, that would be helpful.

Daniel Newman - *GDS Holdings Limited - CFO*

You asked whether the guidance change was related to the acquisition. The answer to that is no. The Guangzhou 2 acquisition has just closed. So we're about 6 weeks from the yearend, so only very short period of time. As it so happens, if you go back to the IPO prospectus, you'll see that we had an MOU for this acquisition some time ago. We thought it might happen earlier, but we waited until certain conditions were right including the redundant power capacity. So we moved ahead when those conditions were met. As relates to area held for future development, I think what we're trying to highlight is that we have projects where you see Phase 1, or Phase 2 even, but we have expansion capacity on those sites. So just to give some examples, in Shenzhen, Shenzhen 4 and Phase 2 is as big as Shenzhen 4 Phase 1. In -- Shanghai 6 is on a site where we have an agreement with the property partner for the build-to-suit lease of 2 datacenters. So the second one which is just dirt on the ground, we've reserved the name Shanghai 7. And in Shanghai 5 we're also in (inaudible) 2 phases. In Chengdu, Chengdu 2 Phase 1 is part of a potentially a much larger construction. And we have land in Kunshan (inaudible), we have a development agreement for a relatively large site in a very prime location in Beijing. So it's actually quite a lot if you add it all up, and it's very much within our control as to when we activate this. And that is part of what gives us confidence about being able to sustain our sales momentum beyond what you see in terms of what's under construction. But I think the point that William was making which I just want to reemphasize is that the market growth opportunity is bigger than we foresaw and which I think anyone foresaw and we have already taken steps to supplement our resource plan in quite a significant way and that will become apparent over the next few quarters.

Operator

(Operator Instructions) As there are no further questions I'd like to now turn the call back over to the company for closing remarks.

Laura Chen

Thank you very much once again for joining us today.

Unidentified Company Representative

Thank you.

Laura Chen

If you have further questions, please feel free to contact GDS' Investor Relations through the contact information in our website or the Piacente Group Investor Relations. Thank you.

Operator

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