

ChinaCache 3Q14 Earnings Call

Thursday, 20th November 2014

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Operator: Ladies and gentlemen, thank you for standing by and welcome to the ChinaCache Third Quarter 2014 Earnings Call. At this time all participants are in a listen-only mode. There will be a presentation followed by a question and answer session; at which time if you'd like to ask a question, please press *1 on your telephone. I must advise you that this conference is being recorded today, Thursday, 20th November 2014. I'd now like to hand the conference over to your first speaker today Ms Brandi Piacente. Thank you, please go ahead.

Brandi Piacente: Hello everyone and welcome to ChinaCache's Third Quarter 2014 Earnings Conference Call. We distributed our earnings release earlier today. If you've not received a copy, you can find it on the Investor Relations section of our website.

Today you will hear from Mr Song Wang, ChinaCache's Founder, Chairman and CEO; Dr Ken Zhang, the company's President; and Ms An Jing, the Chief Financial Officer. There will be a question and answer session following management's prepared remarks.

Before we proceed, please note that today's discussion will contain forward-looking statements made under the Safe Harbor provisions of the US 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. Potential risks and uncertainties include but are not limited to those outlined in our public filings with the SEC. ChinaCache does not undertake any obligation to update any forward-looking statements except as required under relevant law.

Our earnings release in this call includes discussions of certain unaudited non-GAAP financial measures. Our press release contains a reconciliation of the unaudited non-GAAP measures to the most directly comparable unaudited GAAP measures and is available on our website. As a reminder, this conference call is being recorded. In addition, a live and archived webcast of the conference call will be available on our website.

I would now turn the call over to ChinaCache's CEO Mr Wang, who will make his remarks in Chinese, and then I will provide an English translation.

Song Wang: [Mandarin, 02.16–02.45].

Translator: Good morning, ladies and gentlemen. Thank you for joining us to discuss our third quarter 2014 results. I'm very pleased that we sustained the powerful momentum of the first half of the year throughout the third quarter, achieving stable revenue and profit growth, expanding our customer base, introducing new innovative services and making significant progress with our strategic partners.

Song Wang: [Mandarin, 03.09–03.43].

Translator: In 2014, an important strategic objective for ChinaCache is to improve our operations and the efficiency of our business. During first nine months of this year, we invested significantly in R&D to build a new resource management system and a High-Performance Cache Cloud, or HPCC cloud distribution system. These new systems will substantially increase our potential efficiency, capability and leverage from scale. So far I'm pleased that our efforts have started paying off, resulting in three consecutive quarters of profitability.

Song Wang: [Mandarin, 04.20–04.47].

Translator: We continue to serve a rapidly growing market as adoption of broadband internet by enterprises, traditional media, online video/game providers, e-commerce and individual users create a need for efficient content delivery, in particular the availability of the 4G licenses and LTE technology in China is driving the boom in mobile internet use. As such, the CDN industry in China is entering into a high-growth period with overall traffic growth above 50%. A bright future is ahead of us.

Song Wang: [Mandarin, 05.23–06.24].

Translator: We have responded to this market boom in several important ways. First, we have invested in cutting-edge technology to improve speed and stability, including our new resource management systems or super node project and our high-performance Cloud Cache platform. We also continue to innovate and have developed new products and services to target the market's most pressing needs. Along this line, we introduced a new product for the distribution and acceleration of mobile applications. It's called mCloud. mCloud is an integrated solution, customised for a business-to-business-to-customer model allowing 3G or 4G end users from enterprises to accelerate the transmission speeds by 60% while lowering the data cost. mCloud can be used in e-commerce, finance, news, social media, O2O and many other mobile internet areas.

Song Wang: [Mandarin, 07.25–07.59].

Translator: Mobile internet growth has provided the CDN industry with enormous opportunities. During the past quarter, ChinaCache provided CDN solutions for a leading global high tech

company to accelerate its operating system upgrade service in China, which requires a bandwidth of three terabytes. For this same client, we provided CDN acceleration services for its app store, and exclusively supported that localisation of its online map service. During quarter three, we also provided our services to support its online ordering process in China, which ensured the smooth operation of its record-breaking sales events.

Song Wang: [Mandarin, 08.42–09.00].

Translator: Online game broadcasting is a new growth driver for online video companies. Due to [inaudible] ChinaCache managed to facilitate one of our clients to break the daily track record within the industry. Many companies with similar businesses have become other clients and we look forward to continuing to contribute to the growth of the online game broadcasting industry.

Song Wang: [Mandarin, 09.25–09.49].

Translator: Partnership with Telecom has been a significant part of our long-term strategy. I'm pleased to say that, in the third quarter, CCIH won the bid to be the exclusive provider of CDN cloud service for China's mobile government and enterprise customers. It is an exciting opportunity for us to expand our enterprise customer base and to further grow our visibility.

Song Wang: [Mandarin, 10.17–10.21].

Translator: Now, I'd like to report on the progress of our strategic partnership with China Telecom.

Song Wang: [Mandarin, 10.30–11.08].

Translator: ChinaCache is close to finishing the project to help China Telecom Cloud launch its CDN platform including phase one of the node construction and integration project. CT cloud developed 5 additional nodes during the past quarter with the capacity of up to several hundred gigabits and plans to continuously develop more nodes as the partnership progresses. Meanwhile, CCIH has also launched a CT cloud portal project and currently the portal is working well. CCIH and CT are working closely together to develop high-end enterprise customers. In fact, during the past quarter, we successfully signed agreement with our first enterprise client through this cooperation. Our strategic partnership with China Telecom is a long-term relationship and win-win for both companies.

Song Wang: [Mandarin, 12.04–12.20].

Translator: I'd like to update you on the progress of our Data Center business. The structures of all ten buildings have now been completed successfully and on schedule. We will continue to move the project forward smoothly and we will update investors as additional developments warrant.

Song Wang: [Mandarin, 12.39–13.03].

Translator: As the Company and the market opportunity grow, it is also important for us to continually strengthen our management team. We are very fortunate that in Q3, Mr. Liangjun GAO joined CCIH as Chief Marketing Officer. Mr. Gao has 17 years' experience working in multinational companies and over 11 years' experience in senior marketing positions, including VP at Ericsson in China.

Song Wang: [Mandarin, 13.33–14.13].

Translator: Before I turn the call over to Ken, I would like to emphasize our longer term outlook for ChinaCache's competitive position and advantages. Given the growth of broadband adoption in so many areas, and the need to improve China's Internet infrastructure, it allows multiple CDN providers to co-exist within our industry. However, the core competitive advantage of ChinaCache lies in our advanced technologies, high-quality services, abundant operational experience and deep customer base. We believe that our achievements in 2014, including our HPCC distribution system and our super node project, demonstrate our commitment to delivering the best products and services, and remaining a leader in CDN for years to come.

Song Wang: [Mandarin, 15.06–15.06].

Translator: Ken, I will now turn the call over to you.

Ken Zhang: Thanks, Mr Wang. Hello, everyone. Q3 has been a busy quarter as usual. As Mr. Wang said, it carried on the same growth momentum as Q1 and Q2. Revenue increased 36.3% year over year, and 8.4% quarter over quarter. Adjusted EBITDA margin increased another 1% from previous quarter to reach 9.8%. This demonstrates that the company continues to improve its efficiency and its scale leverage.

As we reported in Q1 and Q2, our super node project has progressed well. In Q3 we have further upgraded our traffic and resource management system, which allows us to efficiently balance traffic and bandwidth across the entire network. It means higher efficiency in bandwidth reuse and higher availability for all kinds of applications.

As Mr. Wang said earlier, we have completed the preliminary R&D process for the HPCC (High performance cloud cache) platform. This platform will be able to support all kinds of CDN applications and it is flexible to be deployed on top of any cloud infrastructure. It can further increase system stability and reduce equipment cost. We plan to launch the full platform early next year.

Internal operational improvement is an on-going process within the company. Since we started to implement CRM in ChinaCache during Q3 last year, we have continued to integrate our sales process into the system. CRM is a very important tool to connect the sales team with the company's supporting organization, such as our Resource Management Center and product management group. Now we can clearly see the pipeline of all the business opportunities per month, per product and per customer. With this tool we can better control our resources to support all these opportunities. Sales incentives are also now more closely aligned with company's strategic priorities, like revenue, margin and AR collection.

Now, I would like to talk in more detail about our enterprise business development. We saw another strong quarter for our enterprise business with over 40 new customers added in Q3. The enterprise business contributed 13% of our total revenue in Q3, up from 12% in Q2 of 2014 and 8% in Q1 of 2013. Our enterprise solution team is getting more and more experienced in dealing with enterprises in different verticals, thus we expect to continue our momentum in growing this higher margin business.

Consistent with what we observed in Q1 and Q2, in Q3 we continued to experience a faster growth rate for video applications, including both live streaming and video on demand. We saw growing demand for video bandwidth from large Internet companies, including Tencent, Sohu and Baidu. At the same time, we also saw huge demand from OTT players and traditional TV

stations. As I described last quarter, we signed a contract with Hunan TV for its video delivery service. We saw traffic from Hunan TV increase rapidly from zero in Q2 to over several hundreds of Gb/s in Q3. In the past quarter, we also contracted with Shijiazhuang TV station. Now we have over 20 TV stations signed up with ChinaCache's video delivery service. We believe this trend will continue. Both OTT players and traditional TV stations will play a major role in future video application and services.

In Q3, ChinaCache became the first provider to launch an OTT+CDN platform in China, which combines OTT video technology with CDN. ChinaCache OTT+CDN platform supports full video services, including live broadcasting, and video on demand. From encoding, transcoding and distribution, we provide an end-to-end solution and this platform also allows long-distance delivery of High Definition video. End users will benefit from our advanced technologies and high-quality customer services, and enjoy a fast HD video streaming experience.

Now, I would like to turn the call over to our CFO Jing, for a review of the financial result. Jing?

Jing An: Thank you, Ken. Hello everyone and thank you for joining us on today's call. Today, I would like to start with our Q4 guidance, followed by the review of our third quarter 2014 results. We will then open the call for questions. Please note that, the denominating currency is RMB unless otherwise specified.

In 2014, a significant objective of the company was to enhance operational efficiency. To achieve this, we undertook a number of strategic initiatives including, 1) we streamlined our organisation, 2) we centralised the bandwidth resources and initiated our new super node project, 3) implemented a new resource management system, 4) consolidate and centralised our back-end operation teams and launched our High Performance Cloud Cache platform recently. All of these initiatives have been contributing positively to our result of the profitability during the first nine months of this year.

For the fourth quarter, we are taking a measured approach to the migration of existing customers to our High Performance Cloud Cache platform. We are committed to maintain the quality and the stability of the service of which ChinaCache is known, rather than aggressively pursuing the incremental scale. As a result of this cautious migration, we expect our fourth quarter revenue to be between RMB365 million and RMB370 million, representing 7.6% to 9% growth over the first quarter of the last year and 1.4% to 2.7% decrease over the third quarter of 2014.

We note that, despite the expected impact of the fourth quarter revenue of our customer migration to our new High Performance Cloud Cache platform, the full year revenue gross will be nearly 30%. And once the High Performance Cloud Cache platform is fully launched and debugged, we expect our revenue can grow faster.

In terms of the profitability, based on our current outlook, we believe we can be profitable for both the fourth quarter and the financial year of 2014. This would be a significant milestone for our company and a testament of our commitment and execution of long-term profitable growth. Our long-term outlook for the company remains very positive.

Now turning to our third quarter results. The third quarter net revenue came in within our guidance range. The third quarter net revenue increased 36.3% year-over-year to RMB375.3 million from RMB275.4 million. On a sequential basis the net revenue in the third quarter increased by 8.4% over the second quarter of 2014. The third quarter gross margin

was 30.3%, increasing slightly from 30% in the second quarter. The slight increase in the gross margin was primarily the result of the higher efficiency in the bandwidth utilisation.

In the third quarter, we achieved operating income of RMB10.7 million compared to RMB1 million in the previous quarter. Non-GAAP operating income, which excluded share-based compensation expenses was RMB12.6 million compared to RMB4.1 million in the previous quarter and non-GAAP operating loss of RMB12.2 million in the third quarter of 2013.

We are very pleased that we are achieving strong growth; we maintain control over operating expenses, allowing us to achieve significant economies of scale. Our total operating expenses was RMB103.2 million or 27.5% of the net revenue compared with RMB102.9 million or 29.7% of the revenue in the previous quarter and compared with RMB104.7 million or 38% of the revenue in the third quarter of 2013. The decrease in the total operating expenses as a percentage of the net revenue is a result of the economies of scale and our continued commitment to improve operating efficiency.

Overall adjusted net income were RMB8.9 million compared to RMB11.6 million in the previous quarter. Adjusted net income is defined as the net income before the share-based compensation expenses following exchange gain or loss and the penalties on uncertain tax positions. Our non-GAAP diluted earnings per ADS in the third quarter was RMB0.34, compared to the RMB0.44 in the second quarter. GAAP diluted earnings per ADS in the third quarter were RMB0.02 compared to RMB0.26 in the second quarter.

Adjusted EBITDA was RMB36.9 million in the third quarter and improved by 29.4% from RMB28.5 million in the previous quarter. Adjusted EBITDA margin for the third quarter was 9.8%, compared with 8.2% in the prior quarter. Adjusted EBITDA is defined as EBITDA excluding share-based compensation expenses and foreign exchange gain or loss.

That concludes the financial overview. In summary, I want to emphasise that our results and our guidance demonstrated our commitment to the long-term profitable growth. Now, let's open the call for questions.

Operator: Ladies and gentlemen, we will now begin the question-and-answer session. If you'd like to ask a question, please press *1 on your telephone and wait for your name to be announced. If you'd like to cancel that request, please press the # key. Our first question comes from the line of Kai Qian from CICC. Please ask your question.

Kai Qian: [Mandarin, 29.00–31.17].

Interpreter: Here I have three questions. The first is about the super node construction and move to the cloud platform. So how they impact for financial margins for the next year and which means all the super node constructions should be finalised and we can move through the cloud – cloud platform which I mean how can you impact the margins for the next year? This is my first question.

The second question is about the cooperation with China Telecom about seeking business. And, as we know, China Unicom and China Telecom will set up a JV to do the CDN business in the future. So, please give us some kind of colour and you turnover detail unless it showed impact for the, you know, the whole industry and for the ChinaCache in the future?

The third question is about IDC, and please give us some kind of guidance for the financial impact for the IDC next year, the kind of – in terms of the revenue, in terms of the profit. Thank you.

Song Wang: [Mandarin, 32.33–33.14].

Translator: First of all, I will answer your first question and I will move the following two questions to my colleagues Ken and An Jing. For the HPPC and the super node project, I suppose that by now we have finished around 70% of all the projects, and I suppose that during the following months of this year and the first quarter of next year, the whole project will be complete around the 90%, and by the first six months of next year the project might be finished.

Song Wang: [Mandarin, 33.49–34.30].

Translator: I suppose that generally speaking, by utilising the HPCC and super node project, we could greatly improve our efficiency and management because previously we often choose different projects or platform to manage our different businesses, but by using HPCC and super node project, we could integrate all different kinds of resources by using just a single platform. In this way we can greatly improve our efficiency.

Song Wang: [Mandarin, 35.02–35.02].

Translator: But – I explained my confidence in our superiority over some super internet companies for our integrated service.

Song Wang: [Mandarin, 35.27–35.29].

Jing An: So Kai, could you just – for the sake of this call, could you just help us repeat the second question.

Kai Qian: [Mandarin, 35.41–35.41].

Jing An: Oh, sorry.

Kai Qian: [Mandarin, 35.46–35.48].

Jing An: Okay, so – yeah. I just want to – one point about the – the super node new platform and, I mean, the High Performance Cloud Cache platform, we can say 30% of the storage, that means it can save the capex investment and at the same time on top of the new resource management system, we also can save more bandwidth resource and increase the efficiency.

Ken Zhang: Yes, this is Ken, yeah, I want to add one more thing, is that maybe to make it more clear this basic part of the resource management system is done, but the IMS system will be continued upgrade to optimise to further increase efficiency bandwidth we use. So this is not end – and it will continue to be improved.

Song Wang: [Mandarin, 36.48–37.47].

Translator: Actually, I've also heard lot of rumours in the market about the joint cooperation between the China Telecom and China Unicom but actually as I've just briefed you now that we ChinaCache have already started to establish a joint venture together with China Telecom and, as I have contacted a lot of middle-level and high-level management in the China Telecom, I don't see there is any substantially chance that the two companies will indeed establish a joint venture.

Song Wang: [Mandarin, 38.24–38.45].

Translator: And I like to give you more about the information on the cooperation between ChinaCache and the China Unicom. During the world-cup this year we have actually supported the mobile users in utilising the CDN for their mobiles in watching the World Cup live or the VOD.

Song Wang: [Mandarin, 39.11–39.29].

Translator: For the IDC, I'll just also brief you that by yesterday morning, the ten buildings of the Data Centers have been finished.

Song Wang: [Mandarin, 39.40–39.42].

Translator: Despite the negative impact from the APEC summit, the ten buildings have finished their construction on schedule.

Song Wang: [Mandarin, 39.59–40.10].

Translator: So I'm now convinced that our construction will go smoothly and you will be soon knowing about information on the second building.

Song Wang: [Mandarin, 40.21–40.35].

Translator: And based on the financial regulations, our financial information including the profitability, the margins, earnings, you will see them next year.

Jing An: And I think we'll – I think we will – the earliest time to realise the profitability or the recognizable revenue will start at the second quarter.

Song Wang: Next year.

Jing An: Oh, yeah, next year in 2015.

Kai Qian: Okay. Thank you.

Operator: Our next question comes from the line of Jun Zhang from Rosenblatt Securities.

Jun Zhang: Hi, Wang Song, Jing, Ken. Thanks for taking my question. So my first question is, could you elaborate the reasons behind the Q4 guidance. Do you think it's a short-term trend or it's a long-term trend? Thanks.

Jing An: Hi Jun, let me take the question. And actually the fourth quarter, you know, you know, we are very, very cautiously, to migrate our existing customers to the new platform we have to – we have to guarantee the quality of the service and stability of the service. So we were cautious to immigrate that and so this is very temporarily, the situation, about the guidance for the Q4. And after we finish all the migration and everything settle down we believe that we can grow faster in the coming year. Does that answer your question?

Jun Zhang: Yeah, thanks.

Jing An: Hold on. Mr Wang, please?

Song Wang: [Mandarin, 42.29–42.49].

Translator: And actually for the guidance on Q4, we now are taking a constructive attitude because this is the time for the migration and probably the product might be impacted. So we also take the worst scenarios into the consideration and look forward to the guidance.

Jing An: And even based on the guidance, we still have confidence on our bottom line growth for the fourth quarter and the whole year of 2014.

Jun Zhang: Thanks. So my second question is, what's your strategy to further improve the operating margin in the next few quarters? [Mandarin, 43.34-43.43].

Jing An: You can see that in this year, we already take some initial steps to improve that. And all the optimisation, you know, business are long-lasting actions and we very strictly – to control the budget of our operation and another point is about the gross margin absolute number or the gross profit. We can guarantee that growth is faster than operating expenses and that will contribute to continually – sustainable profitability.

Jun Zhang: Thanks. That's all my questions.

Jing An: Okay, thank you.

Operator: Once again, if anyone would like to ask a question, please press *1 on your telephone and wait for your name to be announced.

Ken Zhang: Okay.

Operator: As we have no further questions, I'll now hand it back to management for any further remarks.

Ken Zhang: This concludes today's earning call. I look forward to having more to share with you on our next earning call. Thanks to all our shareholders, employees, and thanks to everyone on this call for being with us today. Thank you.

Operator: Thank you. Ladies and gentlemen, that does conclude our conference for today. Thank you so much for your attendance. You may all disconnect.

[END OF TRANSCRIPT]