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CCIH - Q2 2015 ChinaCache International Holdings Ltd Earnings Call

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CORPORATE PARTICIPANTS

Song Wang *ChinaCache - Founder, Chairman and CEO*

Ken Zhang *ChinaCache - President*

Jing An *ChinaCache - CFO*

CONFERENCE CALL PARTICIPANTS

Qian Kai *CICC - Analyst*

PRESENTATION

Operator

Hello and thank you for standing by for ChinaCache Second Quarter 2015 Earnings Conference Call.

(Operator Instructions). Today's conference is being recorded. If you have any objections, you may disconnect at this time.

Now I would like to transfer the call to ChinaCache. Thank you. Please go ahead.

Unidentified Company Representative

Hello everyone and welcome to ChinaCache second quarter 2015 earnings conference call. We distributed our earnings release earlier today. If you have not received a copy, you can find it in the Investor Relations section of our website.

Today you will hear from Mr. Wang Song, ChinaCache's Founder, Chairman and CEO; Dr. Ken Zhang, the Company's President; and Ms. An Jing, 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 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. 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 press release and 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 will be recorded. In addition, a live and archived webcast of the conference call will be available on our IR website.

I will now turn the call over to our CEO, Mr. Wang, who will make his remarks in Chinese and then I will provide the translation.

Song Wang - *ChinaCache - Founder, Chairman and CEO*

(Interpreted) Thank you for joining us today. We're pleased to provide updates on many of the operational and strategic initiatives that we mentioned during our last call.

Reviewing the second quarter 2015 results, we saw revenue growth across the video, mobile usage, mobile apps and enterprise sectors.



We optimized our Smart Media Server or SMS in the second quarter. SMS is a proprietary platform that enables interactive live streaming of content in different formats for online delivery to multiple networks, which is built on our cloud-based HPCC platform. SMS satisfies customized solutions including multi-protocol, transcoding, Token and Refer encryptions and live broadcasting to video-on-demand transformation. SMS also enables dynamic intelligent streaming to identify the end-users' internet environment and optimizes the solution, thereby providing customers a one-stop live broadcasting service.

In addition, we continued to strengthen deployment of residential broadband acceleration services and promoted the project development of ChinaCache Hui Wang in the second quarter. Now we partner with more small carriers to reduce their bandwidth pressure as well as bandwidth costs. As of today we have been working with over 10 clients and have 15 nodes distributed around the country, which are specifically dedicated for this project.

Turning to mobile. During the second quarter we added womai.com, chunyuisheng, Ford and ganji.com to our growing list of MPlus clients.

The enterprise segment remained our key area of focus in the second quarter. In addition to winning new clients, we can provide enterprises with the most up-to-date solutions for their needs by leveraging the deep understanding of their business. We signed new agreements with existing clients SF-express, Lenovo, Huawei and Hunan Satellite TV station for additional services.

For our broadcast and television clients, we launched the cloud solutions based on visual data analysis. Through ongoing customized solutions, ChinaCache helps its clients strengthen competitiveness, focus on core business expansion and achieve optimized user experience and speed. We have successfully partnered with broadcast and television clients in many provinces and municipalities including Heilongjiang, Yunnan, Hubei and Shaanxi, after success with Jiangsu Province, Hubei Province, Tianjin, Heze, and Weihai.

The data traffic through Webluker has jumped six times from beginning of this year. In addition, we established a partnership with Kingsoft Cloud, which is a highly regarded cloud service provider in China.

In the second quarter, in addition to serving small and medium-sized enterprises, we explored potential cooperation arrangement with small to medium-sized cloud companies including UCloud, Suzhou International Science-Park Data Center (SISDC) Cloud, and Inspur Cloud, to offer the incubator platform for startups.

As for our the high-performance cloud cache platform, or HPCC, we continue to focus on migration during the second quarter. As of today, 90% of our pages have migrated to HPCC with improved stability.

With significant traffic from our video and live streaming clients, our old platform remained in operation in tandem with our HPCC platform to provide additional capacity for successful transition, while enabling the quality of our services. This is an in-depth process that takes time and resources and created challenges that haven't been previously faced in the CDN industry.

We remain confident that HPCC will lay the foundation for our strategic development in the future. HPCC significantly increases the reuse rate of bandwidth, improves the user experience, lowers client costs, and enhances our ability to sustain operations and perform maintenance. Bandwidth cost as a percentage of total revenues decreased during the last three quarters, further demonstrating how HPCC will improve our overall efficiency.

We're proactively solving the challenges during the implementation process based on the premise that service quality for existing and new customers will not be impacted. We believe these challenges are temporary and that by early 2016 the platform will be stabilized and we are positioned to accommodate market demand and facilitate ChinaCache's growth.

That concludes my opening remarks. Before I turn the call over to our President Mr. Ken Zhang for an operation update, on behalf of the Board and other management team, I'd like to thank him for his contributions over the past years. Ken?

Ken Zhang - *ChinaCache - President*

Thank you, Mr. Wang.

During the second quarter we continued to execute on our growth strategy, and I will provide you with some progresses we made in some of our key strategic initiatives.

SMS. In the first quarter of this year we launched our Smart Media Server, SMS. SMS is a proprietary technology built on our HPCC platform, which enables interactive live streaming of content in different formats, for online delivery to multiple networks. SMS provides enhanced and accelerated distribution of streaming media content, with fewer delay and fewer bottlenecks.

SMS supports both standard protocol and on-demand real-time messaging protocol, enabling developer to create interactive application that includes multimedia content. SMS also supports Shockwave Flash, SWF, Token and Refer encryptions.

In addition, SMS supports several categories of streaming video content, includes HD video network television and media, live game events, and game portals, interactive live broadcasting, education, sport event, conferences, entertainment portals, mobile broadcasting, and other value-added services.

SMS covers almost all video-related applications and provides an unprecedented level of support for streaming media development. In the second quarter we advanced our SMS platform by improving the encoding capability, which will reduce our customer costs, who encode their files before engaging our CDN services.

Now let's turn to NovaCDN. We launched NovaCDN website www.novacdn.com at the end of May. As an extension of our self-provisioned platform Weblucker, NovaCDN provides world-class one-stop CDN solution and cloud hosting services for international customers. Focusing on web performance optimization for international service providers entering China, NovaCDN now serves over 100,000 websites, including Volkswagen and ifeng.com, and has established partnership with over 20 international businesses, including Microsoft and Taiwan's ChungHwa Cloud.

With our extensive coverage in China and globally and the data center located in Beijing, NovaCDN will provide advanced global CDN coverage. And with our proprietary TCP technologies, we can offer optimized transmission and up to twice of the website and file loading speed comparing with any other similar service in China.

NovaCDN is committed to supporting international customer access to the Chinese market to meet their business needs. With NovaCDN, enterprises have entire global network delivering their content rapidly to any device anywhere and any time.

HPCC update. Last but not least, I would like to provide an update on our HPCC platform. As Mr. Wang mentioned earlier, the coexistence of old platform and HPCC creates operating and service issue, Specifically, the greatest challenge was to have two platforms running simultaneously to ensure sufficient bandwidth resources for our customers. The HPCC itself is a new technology going through a breaking-in period and we are making constant improvement. Our team is also becoming more familiar with HPCC platform and is accumulating the experience required to once again have ChinaCache set the industry standard.

Also we encountered some challenge in HPCC stabilization process. We will continue to cautiously advance the migration process while sustaining the utmost service standards for our clients.

Before I turn over the call to An Jing, I want to say a few words about my leave as announced last week. I will step down as President of the Company after four years operation; I will pursue my personal interest in the U.S. I will remain as adviser till the end of the year.

I want to express my sincere gratitude to all of your support through the year. And please extend this support to the new management.

Now I hand over to An Jing, please.

Jing An - ChinaCache - CFO

Thank you, Ken. Hello everyone and thank you for your participation.

Today my presentation will include our guidance for the full year of 2015 as well as the second quarter 2015 financial results. Please note that the denominating currency is RMB unless otherwise specified.

In the second quarter ChinaCache recorded net revenue of RMB353.3 million, a 2% increase year over year. This lower-than-expected revenue growth was mainly due to the difficulties and issues we encountered during the migration of our HPCC platform that Mr. Wang and Ken have discussed.

As a result, our revenue in the second half of the year will be lower than expected. Currently we expect our full year 2015 revenue to be between RMB1.4 billion and RMB1.47 billion. However, we still have the capability to improve the operational efficiency of the Company as demonstrated by our adjusted EBITDA margin of 12.8% for the first half of 2015, compared with our adjusted EBITDA margin of 8.1% for the first half of 2014. We expect to continue to maintain the operational efficiency while we work towards improving the top line growth.

Before I begin to review the second quarter results, I would like to share with you our perspectives on how ChinaCache is well-positioned to be competitive in this market.

We remain one of the top providers in the fast-growing CDN market. And given our current revenue and customer base, we believe the traffic from our customers will ramp up quickly once our platform implementation and optimization are completed.

We have a strong track record of developing and delivering innovative solutions to many top-tier internet customers. We will continue to invest in the advanced technology and high-performance areas such as the mobile-related products, cloud computing, and enterprise focused sectors, in order to fuel our competitive advantage.

Now let me highlight the second quarter of 2015 results.

The second quarter's gross margin was 27.4%, compared with 29.5% in the previous quarter. Excluding the share-based compensation, the second quarter gross margin was 27.7%, compared with 29.9% in the previous quarter. The decrease in gross margin was mainly due to expenses for the extra consumable hardware purchase related to the platform upgrades.

Despite this lower revenue growth, we were able to control the bandwidth cost for the second quarter. The bandwidth cost as a percentage point of the revenue decreased from 65.2% in the previous quarter to 53.8% in this quarter. This decrease gives us a sense of how a fully stabilized HPCC will improve our bandwidth utilization and have fundamental advantage over the previous platform.

We expect to maintain a reasonable margin and bandwidth cost as a percentage to the total revenue in the second half of this year.

In the second quarter, the non-GAAP operating income, which excludes share-based compensation expenses, was RMB1.5 million, compared with non-GAAP operating income of RMB14.1 million in the previous quarter and non-GAAP operating income of RMB4.1 million in the second quarter of 2014.

Looking at operating expenses. Our general and administrative expenses for the second quarter was RMB54.5 million, representing 15.4% of the net revenue, compared with RMB49.7 million or 13.7% of the net revenue in the previous quarter.

Sales and marketing expenses for the second quarter were RMB25.5 million or 7.2% of the net revenue, a decrease from 8.8% of the revenue in the previous quarter. Total sales and marketing expenses decreased 19.8% quarter over quarter and 27.8% on a year-over-year basis, primarily due to the improved operating efficiency and effective cost control.



R&D expenses for the second quarter were RMB26.8 million or 7.6% of net revenue, compared to RMB27 million or 7.4% of the net revenue in the previous quarter, which remained stable from the previous quarter and a 10.7% decrease from the corresponding period in 2014. The overall decrease in the first half of 2015 was mainly due to the significant investment expenses we incurred through our 2014 to advance our infrastructure development.

Our R&D expenses in the second quarter of 2015 have returned to a normal level. Our total operating expenses were RMB106.9 million or 30.2% of the revenue, compared with RMB108.5 million or 29.8% of the revenue in the previous quarter.

Adjusted net income in the second quarter was RMB4 million, compared with RMB10.4 million in the previous quarter and [RMB11.6 million] (corrected by company after the call) in the corresponding period in 2014. Our non-GAAP diluted earnings per ADS in the second quarter was RMB0.15.

Adjusted EBITDA was RMB41.8 million in the second quarter, compared with RMB49.7 million in the previous quarter, and RMB28.5 million in the corresponding period in 2014, representing a year-over-year growth of 46.6%. Adjusted EBITDA margin for the second quarter was 11.8%, versus 8.2% in the corresponding period in 2014. The stability in our adjusted EBITDA margin shows improvement in our operating efficiency despite the temporary slowdown of our top line. We believe we are capable of maintaining a reasonable profitability growth rate when the growth in the revenue resumes.

Moving to the balance sheet. We had RMB649.5 million in cash and cash equivalents as of June 30, 2015, compared with RMB375.9 million as of December 31, 2014. Our cash position improved primarily because of the cash prepaid by customers for our cloud datacenter.

In the second quarter, our DSOs were 110 days, compared with 101 days in the previous quarter. Our capital expenditure in the second quarter were RMB25.2 million, which represents 7.1% of the total revenue.

We remain excited about ChinaCache's future and committed to creating long-term value for our shareholders. As such, we will continue to execute our share repurchase program.

This concludes my remarks. Now let's open the call for questions.

Unidentified Company Representative

Operator, please go ahead.

QUESTIONS AND ANSWERS

Operator

Ladies and gentlemen, we will now begin the question-and-answer session. (Operator Instructions).

Your first question comes from the line of Qian Kai of CICC. Please ask your question.

Qian Kai - CICC - Analyst

(Chinese language spoken)

Okay, I have three questions. The first one is about the top line growth. So, behind the weak top line growth, any color about kind of the reasons behind the, you know, related to the new platform?



The second question is, beside the negative impact for the top line, any positive improvement for our operating efficiency due to the new platform?

And the third question is how to drive the top line growth in the next year. Thank you.

Song Wang - *ChinaCache - Founder, Chairman and CEO*

(Interpreted) Okay. Your question is about income during the second quarter and the third quarter, which is pretty good, and thank you for asking.

And actually in terms of the performance of the HPCC, perhaps in the beginning we have already underestimated all the difficulties. As of today, 90% of our pages have successfully migrated to HPCC, with improved stability.

And as we are seeing that in the beginning of the second quarter we have received a lot of declines in large accounts, taking Tencent for example, they began to transform their videos to our platform. For example, now Tencent began to transform the program with the name of Voice of China to our platform. This will cost a huge room in our platform. For example, they asked us to prepare double preparation. This will cost us a lot of room.

And in the second quarter, meanwhile, the Microsoft also raised a similar requirement. This means that we have to prepare and use up two rooms for the existing programs. Currently the Apple company also began to update their iOS systems. This will also use our platforms. So for the requirements from the big clients, we cannot find we could update and keep the speed of the clients. It means that a lot of requirements from the new clients will be delayed and postponed.

Actually the migration platform is a big issue for us. For example, the CDN migration is a little bit difficult. But based on our previous experience, the platform migration for the B2A offer costs a lot of time and energy. Let's take the AliCloud for example. It took them around four to five years to finish the whole migration. So even in front of so many difficulties, I'm fully convinced that in the third and fourth quarters we will be rising to the challenges and solve all the difficulties.

After the success of migration, we believe that the increase of the existing clients as well as the increase of the new clients will be registering upward trend.

Jing An - *ChinaCache - CFO*

I think Wang-zong already answered the first and your third questions, so I will take the second question about the operating efficiency.

As you see, our adjusted EBITDA margin is improved. Let me tell you some numbers. In the second quarter of 2014, adjusted EBITDA margin is 8.2%, and this year second quarter is 11.8%. 2014, the first half, is 8.05%, and 2015 the first half-year is 12.75%.

So the improvement of adjusted EBITDA margin comes from two factors I think. The first one is the improvement of bandwidth utilization, and that comes from the new platform. During last four quarters, our bandwidth cost as a percentage point of revenue continually decreased from 57.8% to 53.8% of this quarter.

Second improvement comes from the operating efficiency. We employed very strict budget control and the whole management team is focused on the operating efficiency improvement. So that helped us to decreased OpEx as a percentage point of the revenue.

The second quarter of 2014, the operating expenses as a percentage point of revenue is 28.9%, and this quarter it's 27.2%. The first half of 2014 is 29.1% and the corresponding period of this year is 26.6%. And also the absolute number year over year decreased by 3.8%. So I think that answers your question.



Qian Kai - CICC - Analyst

(Chinese language spoken)

So my follow-on question is about the competition from the new internet companies who are providing the cloud CDN service like Leshi TV, they are providing such kind of service for the internet user to use kind of the cloud CDN. So, any comments?

Song Wang - ChinaCache - Founder, Chairman and CEO

(Interpreted) Yes, I see your point. Thank you for your question.

Now more and more internet companies began to provide free CDN service to the companies, I agree with you. But most of the target groups are small-sized companies, and these services, they are going to provide the preliminary CDN. If you are a professional company, most of the time you will not look to these new online internet companies.

You gave us the perfect example of the Leshi TV who gave free CDN to the small-sized enterprises. Like Youku Tudou or YouTube a few years ago, even until now, Youku and Tudou in China provided free CDN to the video providers. Now you could upload your videos online on the website of Tudou and Youku, but still they are going to do some marketing. For example, they could add some advertisements on the video.

Operator

Your next question comes from the line of Jun Zhang of Rosenblatt Securities. Please ask your question.

Jun Zhang - Rosenblatt Securities

Good morning. Thanks for taking my questions. So I have two questions.

One is, could you give us some update on your IDC business?

And the second question, what's your plan and the target to grow your IDC business in the next couple of years? Thanks.

Song Wang - ChinaCache - Founder, Chairman and CEO

(Interpreted) Yes. Thank you for asking.

Currently the (inaudible) in our Beijing datacenter is working smoothly, and by far the interior decoration and power supply have almost finished.

Currently speaking, the data center consists of 4,000 racks and it is in the process of equipment installation. And we currently plan to begin trial run toward the end of 2015 and official commercial launch in early 2016. After its completion, it will become the biggest datacenter in Beijing.

As I mentioned before, in this November we will begin the trial run and now the current clients still have the total number of current clients is already beyond our expectations.

The name of datacenter is Shouming and actually by the end of the completion, we suppose that it could accommodate more than 10,000 racks.

When it's finished, we will create a regional cluster and we will realize the connectivity.

By this November, we are going to create the first internet exchange center within all the top brands.



The clients in the exchange center include the connectors, the content providers and operators.

Their connectivities could be realized through our platform in the exchange center.

It will help them to save money.

The user experience will be improved and the caching will be safe.

Actually the exchange center with the function of connectivities have already been widely accepted in other countries.

For example, in North America, there'll be more than 80 exchange centers.

As of today, in China we have no such exchange center.

In the future we'll be putting our focuses and efforts in bringing up the cluster of the exchange centers and we'll make the connectivity a real-life event, we'll have this happen in the cross-region places and we'll be using and utilizing our private (inaudible) to help us reach the target.

On one hand this is the platform we could help our clients to realize the connectivity and on the other hand we will provide solid foundation for the expansion of the CDN.

Jing An - ChinaCache - CFO

Okay. So that's our answer.

Unidentified Company Representative

So, thank you, and thank you again for joining us today. If you have any further questions, please feel free to contact the Investor Relations of ChinaCache or the TPG Investor Relations. Have a good day.

Operator

Ladies and gentlemen, that does conclude our conference for today. Thank you for participating.

Editor

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