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CCIH - Q3 2016 ChinaCache International Holdings Ltd Earnings Call

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## CORPORATE PARTICIPANTS

**Celine Zhang** *ChinaCache International Holdings Ltd. - IR Manager*

**Song Wang** *ChinaCache International Holdings Ltd. - Founder, Chairman, CEO*

**Eric Zhou** *ChinaCache International Holdings Ltd. - Interim CFO, SVP, Corporate Strategy & Investment*

## CONFERENCE CALL PARTICIPANTS

**James Wang** *Deutsche Bank AG - Analyst*

**Tina Hou** *Goldman Sachs Group Inc. - Analyst*

## PRESENTATION

### Operator

Ladies and gentlemen, thank you for standing by, and welcome to the ChinaCache Third Quarter 2016 Earnings Conference Call. (Operator Instructions) I must advise you that this conference is being recorded today.

And I'd now like to hand the conference over to your first speaker, Ms. Celine Zhang, Investor Relations Manager for the company. Thank you. Please go ahead.

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**Celine Zhang** - *ChinaCache International Holdings Ltd. - IR Manager*

Thank you, operator. Hello everyone, and welcome to the third quarter 2016 earnings conference call for ChinaCache. We distributed our earnings press release earlier today via newswire services. You can also download it from the Investor Relations portion of our website.

Today's call will consist of management's prepared remarks, followed by a Q&A session. Leading today's call is Mr. Song Wang, ChinaCache Founder, Chairman and Chief Executive Officer, who will provide updates on the business strategy; Mr. Eric Zhou, Senior Vice President and Interim CFO of ChinaCache, will then review the company's third quarter 2016 financial results.

Before we begin, please allow me to remind you of the Safe Harbor statement. During today's conference call, we may make some forward-looking statements, statements that are not historical facts, including statements about future expectations, plans and prospects. Forward-looking statements are subject to risks and uncertainties that may cause actual results to differ materially from our 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 laws.

Our earnings press release and this conference call includes discussion 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 recorded. Finally, an archived webcast of the conference call will be available on our website approximately two hours after the conference call concludes.

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

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**Song Wang** - *ChinaCache International Holdings Ltd. - Founder, Chairman, CEO*

(interpreted) Thank you, everyone, for attending today's ChinaCache third quarter 2016 earnings conference call.



During the third quarter, we took a number of measures to improve our operations. First, regarding the HPCC platform, we continued to make progress to optimize its performance. We have now completed most of the planned optimization tasks and are seeing improved platform performance. For example, in terms of the scalability, maintenance and the term for product customization, the new platform has reached the performance of the old platform.

Second, we are upgrading our network's capacity without increasing the number of the servers. When completed, we expect to double the bandwidth capacity per server or per node at selected locations. This upgrade strengthens our ability to serve our large customers. In some cases, we've seen the peak bandwidth to serve some customers more than double. We are prioritizing our resources to serve our customers better. And today, we are setting customer satisfaction as our top priority and winning our customers' support and business by delivering outstanding products and services.

Third, we believe we have one of the best recognized brands in the overseas market that has driven many of the international companies and keeping winning new overseas customers. Leveraging the strong brand awareness in third quarter, we invested approximately \$3.5 million in the U.S. to expand our global R&D and support capacity.

Fourth, to enhance our competitive positioning within the CDN industry, we are transforming ourselves from a pure CDN provider to a total solutions provider. We are building a new generation data center network. With content and applications as the core of our network, we believe our new three-layer structured network consisting of the IDC, Internet and cloud exchange centers, and extensive CDN nodes will emerge as one of the best business models in the Chinese CDN industry and deliver superior value to our customers. We are in the process of deployment and expect to expand our services shortly.

In addition to help our turnaround initiatives, we are considering a corporate restructuring program. We plan to spin off a portion of our data center business. This consideration is detailed in our earnings release. When completed, this restructuring would reduce our need for future capital expenditures, strengthen our balance sheet and at the same time, allow us to participate in the future upside of the data center operations.

Next, I need to mention that following the U.S. District Court for the Central District of California, August 15, 2016 dismissal of the previously announced class action litigation originally filed against ChinaCache, the plaintiffs amended and re-submitted its complaint in September. The company has again moved to dismiss the amended complaint, and a hearing is set before the court on the company's motion in the first quarter of 2017.

Finally, as we turn the corner to 2017, our goal is to regain market share and enhance our position as the leading CDN provider in China. We believe our focused turnaround efforts to further develop and enhance our innovative and leading three-layer network structure, that is ChinaCache data center network, Internet and cloud exchange centers and extensive CDN nodes, will be productive. We believe we are at a transition point in our turnaround plan and look forward to updating you on our progress in the future.

This concludes my prepared remarks. Now I'd like to turn the call over to Eric. Thank you.

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**Eric Zhou - ChinaCache International Holdings Ltd. - Interim CFO, SVP, Corporate Strategy & Investment**

Hi, everyone. This is Eric. For the third quarter of 2016 financial results, net revenues were RMB261.6 million, a 0.1% increase from the previous quarter and a 19.5% decrease from the corresponding period in 2015. Cost of revenues decreased by 3.9% quarter-over-quarter and 2.3% year-over-year to RMB255.1 million. Gross margin was 2.5% compared with negative 1.5% in the previous quarter and 19.6% in the corresponding period in 2015.

Non-GAAP gross margin, which excludes share-based compensation, was 2.6% compared with negative 0.7% in the previous quarter and 19.8% in the corresponding period in 2015. The increase in gross margin in the third quarter of 2016 from the previous quarter was mainly attributable to improved bandwidth utilization.

Sales and marketing expenses were RMB23 million or 8.8% of net revenues, a 5.7% decrease over the previous quarter and an 18.2% decrease from the corresponding period in 2015. The decrease in sales and marketing expenses in the third quarter of 2016 from the previous quarter was primarily attributable to cost control measures.

General and administrative expenses were RMB62.2 million or 23.8% of net revenues, a 4.4% decrease from the previous quarter and an 86.6% increase from its corresponding period in 2015. The decrease in general and administrative expenses in the third quarter of 2016 from the previous quarter was primarily attributable to a decrease in share-based compensation expenses.

Research and development expenses were RMB24 million or 9.2% of net revenues, a 10.7% decrease from the previous quarter and a 1% increase from the corresponding period in 2015. The decrease in research and development expenses in the third quarter of 2016 from the previous quarter was primarily attributable to cost control measures.

Net loss was RMB94.3 million compared with a net loss of RMB108.9 million in the previous quarter, and a net loss of RMB39.4 million in the corresponding period in 2015. Net loss per basic and diluted American depositary share or ADS for the third quarter of 2016 was RMB3.68 each. Each ADS represents 16 ordinary shares of the company.

Adjusted net loss, defined as net loss before share-based compensation expenses and foreign exchange gain or loss, was RMB86.6 million compared with adjusted net loss of RMB91.4 million in the previous quarter and adjusted net loss of RMB44.4 million in the corresponding period in 2015. Non-GAAP net loss per basic and diluted ADS for the third quarter of 2016 was RMB3.36 each.

As of September 30, 2016, we had cash and cash equivalents of RMB253 million compared with RMB606.8 million as of December 31, 2015. Capital expenditures, excluding capital expenditures for the cloud infrastructure-related construction in the amount of RMB77 million for the third quarter 2016 were RMB58.1 million.

And now turning to our outlook. We maintain our previously stated full year revenue guidance. For the full year 2016, we expect revenues to be between RMB1.04 billion to RMB1.1 billion. This outlook reflects our current estimates which is subject to change.

This concludes my prepared remarks. Now, let's begin the Q&A session. Operator, please go ahead.

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## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions) Our first question comes from the line of Kevin Liu from Rosenblatt Securities. Please go ahead.

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### Unidentified Participant

I was representing Jun Zhang from Rosenblatt Securities. So my first question is what is the competitive landscape for CDN in China right now? Any chance to regain shares back?

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### Song Wang - ChinaCache International Holdings Ltd. - Founder, Chairman, CEO

(Spoken in foreign language).

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### Eric Zhou - ChinaCache International Holdings Ltd. - Interim CFO, SVP, Corporate Strategy & Investment

I'll do a quick translation.



**Song Wang** - *ChinaCache International Holdings Ltd. - Founder, Chairman, CEO*

(interpreted) The CDN industry in China is becoming increasingly competitive. Besides some traditional CDN providers like ChinaNetCenter, ChinaCache and a couple of other cloud providers, there are approximately 40 other CDN providers in China. And in addition, some large Internet companies are also setting up their in-house CDN and so the industry is becoming more and more competitive. But on the other hand, we believe it illustrates the fact that the CDN industry in China has a huge market and is still project to grow.

And it's different from the CDN market in the U.S. In the U.S., the CDN providers like Akamai, they are transforming themselves from a pure CDN provider to a company providing, for instance, like Internet security service and products.

And in China, most participants, they are doing the traditional and simple CDN services.

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**Unidentified Participant**

Okay. Thanks. I have another question. So what is the update on data center and the Internet Exchange center? Could you give us more color on what revenue contributions it could be for the next two years? Thanks.

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**Eric Zhou** - *ChinaCache International Holdings Ltd. - Interim CFO, SVP, Corporate Strategy & Investment*

(Spoken in foreign language).

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**Song Wang** - *ChinaCache International Holdings Ltd. - Founder, Chairman, CEO*

(interpreted) And this business is developing fast and for instance, one of the buildings, number three building in our data center and it has already start operations and in the process of launching about 1,500 cabinets.

And in addition, our building number five and the six will start to provide services at the end of this year.

And for Internet and cloud exchange centers and we're also growing and have enjoyed very rapid growth. And for every month, we have new customers coming in.

And the customers including some of the best Internet companies in the world, they are connecting to our Internet Exchange centers. And I believe this market has huge upside potential in the future.

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**Operator**

The next question comes from the line of James Wang from Deutsche Bank. Please go ahead.

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**James Wang** - *Deutsche Bank AG - Analyst*

(Spoken in foreign language). Should I translate the question?

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**Eric Zhou** - *ChinaCache International Holdings Ltd. - Interim CFO, SVP, Corporate Strategy & Investment*

Yes, please.

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**James Wang** - Deutsche Bank AG - Analyst

Yes. So the first question is so you mentioned in the second quarter results that a lot of the customers or some of the customers have moved their bandwidth or their network usage back to ChinaCache, but we haven't seen any improvement in the revenue quarter-on-quarter. I'm just wondering what the reasons are. And the second question, just your expectation on when the gross margin will return to prior period levels? Thanks.

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**Song Wang** - ChinaCache International Holdings Ltd. - Founder, Chairman, CEO

Okay. (Spoken in foreign language).

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**Eric Zhou** - ChinaCache International Holdings Ltd. - Interim CFO, SVP, Corporate Strategy & Investment

Okay, I'll do the translation.

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**Song Wang** - ChinaCache International Holdings Ltd. - Founder, Chairman, CEO

(interpreted) And basically, it's still due to a couple of factors. One is, of course, pricing is a fact. We still see steady declines in CDN prices which would offset some of our new revenues. Second is because we are still in platform transforming processes and we still need to improve our network utilization and our bandwidth utilization as well as we need to further adjust the customer structure for our business. And in addition, we need to take a couple of other efforts to improve the overall efficiency of our business.

What is the last question? The second question.

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**James Wang** - Deutsche Bank AG - Analyst

Just the gross margin, (spoken in foreign language). So the next question, just when you expect gross margin will return to, say, FY '15 levels.

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**Eric Zhou** - ChinaCache International Holdings Ltd. - Interim CFO, SVP, Corporate Strategy & Investment

Right now, I believe we have many elements in place. For instance, we are continuing on optimizing our model and we have seen improved performances. We also have -- in the process of optimizing our customer structure and hopefully in the future, we can keep more high gross margin customers. And also, we are in the process of launching our new so-called end-to-end business model, and we expect to pick up some volume in the future. So even though at this time, it's very difficult to pinpoint a specific point for the improved gross margins, but we are confident that in the coming quarters, we are going to see stable or improved margins.

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**Operator**

(Operator Instructions) The next question comes from Tina Hou from Goldman Sachs. Please go ahead.

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**Tina Hou** - Goldman Sachs Group Inc. - Analyst

My first question is that related to CDN. How has the CDN competitive environment been in during the fourth quarter? Do you see the competition stabilizing or is it still very aggressive price? Have you seen still very aggressive price cuts? And also, how much has the CDN price declined this year?



**Eric Zhou** - *ChinaCache International Holdings Ltd. - Interim CFO, SVP, Corporate Strategy & Investment*

(Spoken in foreign language).

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**Song Wang** - *ChinaCache International Holdings Ltd. - Founder, Chairman, CEO*

(interpreted) And the business is becoming more and more competitive because we have new cloud-based newcomers and also, we have some startup companies that are coming to the industry. And some of them, their pricing is not rational and they are providing services below cost, but we believe this kind of thing will not be sustainable.

And for us, our strategy in the coming days is try to selectively serve a few customers. And we'll be very cautious towards some of the low-margin or negative-margin products such as the video or live streaming.

Of course, we have seen huge demand for the CDN products. And we -- and for these reasons, we try to using this opportunity to adjust our strategy.

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**Eric Zhou** - *ChinaCache International Holdings Ltd. - Interim CFO, SVP, Corporate Strategy & Investment*

And for the second question, for the CDN pricing, the changes -- the price changes basically vary from -- depending on the products, from several percentages to as much as 20% to 30% for some like VOD or Video-on-Demand or streaming products.

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**Tina Hou** - *Goldman Sachs Group Inc. - Analyst*

Great, thank you very much. And just to follow up on the live streaming and online video business. Wondering how much of your revenue is composed of these two segments? And also if you are -- if your strategy is to focus the -- is to focus away from the live streaming and online video business, how much growth does the rest of the space have in terms of the CDN demand?

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**Eric Zhou** - *ChinaCache International Holdings Ltd. - Interim CFO, SVP, Corporate Strategy & Investment*

(Spoken in foreign language).

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**Song Wang** - *ChinaCache International Holdings Ltd. - Founder, Chairman, CEO*

(interpreted) For the VOD and live streaming business, we have approximately 25% to 30% of our revenue.

And we -- we are -- it's not that we are not going to develop a products or develop a business in this segment. And because in this business, right now, a lot of providers, I think their services are quite so-called chaotic because some companies have sustainable business model and some companies may not be profitable. So it's very risky to be in this segment of the CDN industry.

The risks for this segment is high because the pricing from some of the customers are extremely low. Also, the payment terms is not very good. Their account receivable days are quite long. And of course, the video segment, the products, the percentage in the revenue were becoming larger and larger.

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**Tina Hou** - Goldman Sachs Group Inc. - Analyst

Thank you very much, management. Just one more follow-up. So in the traditional CDN business, i.e. excluding the VOD and live streaming segments, have you seen other cloud providers such as Ali and Tencent Cloud coming into this -- coming into the enterprise and government segment for the big enterprise customers such as in finance?

**Eric Zhou** - ChinaCache International Holdings Ltd. - Interim CFO, SVP, Corporate Strategy & Investment

(Spoken in foreign language).

**Song Wang** - ChinaCache International Holdings Ltd. - Founder, Chairman, CEO

(interpreted) And of course, they may target these customers, but I believe as a public cloud provider such as Ali, Tencent, [Jinshan Cloud], and it will be difficult for them to compete in today's enterprise and government markets.

**Operator**

(Operator Instructions) If there are no final questions, I will hand back to management for closing remarks.

**Celine Zhang** - ChinaCache International Holdings Ltd. - IR Manager

Thank you again for joining today's earnings conference call. If you have any further questions, please feel free to contact us through the information available on our website. Thank you.

**Operator**

Thank you very much. Ladies and gentlemen, that does conclude the conference for today. Thank you for your attendance. You may all disconnect.

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