ChinaCache 2Q14 Earnings Call

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Operator: Good afternoon. My name is Jason and I will be your conference operator today. At this time, I would like to welcome everyone to the ChinaCache Second Quarter 2014 Earnings Conference Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session.

If you would like to ask a question during this time, simply press * and then the number 1 on your telephone keypad; if you would like to withdraw your question, press the # key. Thank you.

I would now like to turn the call over to David She, VP of Finance for ChinaCache. Sir, you may begin your conference.

David She: Hello, everyone, and welcome to ChinaCache Second Quarter 2014 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 Song Wang, our Founder, Chairman and CEO; Dr. Ken Zhang, our President; and Ms Jing An, our CFO. 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 harbour 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 press release and this call include 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 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 an English translation.

Song Wang: [Mandarin, 02.38–02.44].

David She: Good morning, ladies and gentlemen. Thank you for joining us to discuss our second quarter results.

Song Wang: [Mandarin, 02.51–03.51].

David She: I am very pleased that during the second quarter of 2014, ChinaCache again achieved strong growth in total revenue, reflecting our position as the leader of Internet content and – and application delivery services in China, along with the strong demand for our advanced technologies and services.

Our net revenue for the second quarter exceeded the top end of our guidance range, reaching RMB346.3 million, representing a 34.4% year-over-year increase with adjusted net income in the second quarter reaching RMB11.6 million. In addition, we continue to see healthy growth in our customer base.

The first half of 2014 exceeded our expectations and we are highly confident that ChinaCache will continue upon its growth trajectory for the remainder of 2014 and onwards. I would like to thank all of our dedicated employees and management team for their tremendous contributions in these efforts.

Song Wang: [Mandarin, 04.57–05.36].

David She: During the second quarter, we continue to see deepening evolution of the Internet with mobile users and mobile traffic rising rapidly. The Internet continues to penetrate and restructure traditional industries such as travel, dining and education. Internet giants such as – as well as emerging vertical industry leaders continue to realise strong growth during the second quarter and are accelerating their deployments on mobile portals.

The fast growth in mobile data traffic and the evolving industry landscape, all very much depend on the stability and optimisation of the Internet infrastructure. This presents tremendous growth opportunities for ChinaCache.

Song Wang: [Mandarin, 06.23–06.26].

David She: Next, I would like to comment upon some important operating developments during the second quarter.

Song Wang: [Mandarin, 06.34–07.25].

David She: First of all, we continue to push forward our cooperation with China Telecom, to jointly construct CDN networks. So far, over 1,000 China Telecom employees have received training and we have also completed a construction of five out of 13 service nodes in phase I of the joint efforts, with plans underway for phase II and Phase III.

The partnership is very important to both parties. Traditional carriers need to transition from voice transmission to data transmission and continuously optimise their backbone network, whereas ChinaCache could capitalise on large carriers branding bandwidth resources and customer base to strengthen and expand the structure and efficiency of our CDN platform.

As the Internet infrastructure continues to evolve, the partnerships between CDN service providers and domestic and global carriers such as our cooperation with China Telecom are expected to be an important trend.

Song Wang: [Mandarin, 08.29–09.44].

David She: As part of our strategic efforts to grow internationally and become a global leader in content delivery, we announced three key additions – sorry, two key additions and one now to our management team during the second quarter.

We appointed Yali Liu as our Vice President of Global Business Development where she leads our business development activities with carriers, content providers, media and enterprise customers globally. Yali was previously with Verizon and played a key role in expanding Verizon's data services to more than 140 countries.

We also appointed Rene Bos as our Vice President of Global Corporate Development where he spearheads our worldwide marketing initiatives. Rene comes to ChinaCache from leading international market research companies such as SSI and Nielsen where he assumed high level management responsibilities.

Lastly, we have just hired Mr HOU, Xiaoyang as Vice President of Carrier Development. Mr Hou has over 18 years of experience at China Mobile and has very deep understanding in telecom carriers. This will be very beneficial for our future business development efforts with carriers.

We believe the appointment of Yali and Rene and Mr Hou and their vision and experience will enable us to better explore the opportunity to work with carriers and other partners both domestically and globally.

Song Wang: [Mandarin, 11.26–12.51].

David She: Next, I would like to report that ChinaCache's Atecsys Cloud Data Centre project is underway with intense construction activity and the entire building foundation of the project has been completed. We expect the initial construction to be completed by end of this year and the first building be put into service next June.

ChinaCache Atecsys Cloud Data Centre is the first of its kind in data centre industry. It set itself apart from traditional service providers with its fast turnaround time which mitigates reliance on future leasing income to recoup investment outlay and the provision of continued total solution support after sale which brings recurring revenue streams with enhanced customer stickiness.

With the dramatic increase in information flow as well as storage needs, large scale Internet firms and traditional enterprises see more and more urgent need to build their own computing power. However, there is no customised product currently available that is similar to our Atecsys project.

By purchasing the customised data centre from ChinaCache, our customers lock in the future cabinet cost, hedge the increasing land and power cost expected under a leasing model and

benefit from holding the data centre as a long-term asset. We are very optimistic about this innovative business model.

Song Wang: [Mandarin, 14.25–14.51].

David She: In June, we were delighted to successfully host the 2014 GCDN Conference in Beijing for the second consecutive year. GCDN is one of the most influential conferences in our industry today both within China and internationally. The conference highlights CDN as the key carrying and dispatching service infrastructure across all major Internet industry verticals.

This year, we also expanded the conference agenda to include more keynote speeches and panel discussions on important industry trends such as mobile Internet, cloud computing, online broadcasting and videos, and internet-connected vehicles.

Song Wang: [Mandarin, 15.34–16.49].

David She: For the immediate past in this fast growing Internet space, we are also noticing some important trends in the video business segment. Video accounts for more than 50% of total Internet traffic in both China and the US. While we are seeing tremendous growth for Internet video portals, many national and provincial level TV stations are also getting up – setting up their own new media department in an effort to transform from a traditional media into an Internet outlet. The Internet as an emerging broadcast channel is becoming an important settlement – supplement or even overturning power to radio and television broadcasting.

TV stations traditionally sell the copyright to Internet channels but now are switching to broadcasting on their own website, sometimes exclusively for popular content. We believe the transitioning of traditional media will be the extension and deepening of the explosive growth for Internet videos. And our value is best demonstrated by addressing the needs of these traditional media for their transition towards Internet media, lowering their transition cost and ensuring stable and cost-effective content distribution. This trend is very similar to the past TV stations such as ESPN and HBO went through in the US and Europe.

Song Wang: [Mandarin, 18.13–19.19].

David She: We are also delighted to observe some dramatic change in the gaming sector. In 2013, the global market size for console games exceeded RMB160 billion and accounted for over one-third of the entire electronic game space. However in China, console games were prohibited by government policy in 2000. And this prohibition was just lifted in January of this year.

We have recently launched support for Microsoft Xbox touching ground in August. We also expect Sony PlayStation4 to be releasing in China soon and we will also be conducting a networking support.

As console games continuously become more high-definition, interactive and bigger in size, we expect tremendous growth in content downloads, and we have significant experience addressing this need. Looking into September and fourth quarter, we are also expecting major handset releases and corresponding software upgrades. As a result of this development, I am very much confident in ChinaCache's subsequent growth.

Song Wang: [Mandarin, 20.29–21.16].

David She: With the support from both the industry and the government, we believe that CDN technology as an upgrade to basic telecom service will continue to thrive. We believe the core value of the CDN technology is to lower the entry barrier for our customers into the Internet industry and provide a total solution platform based on CDN services as well as Big Data and cloud computing.

With our nationwide service node coverage, precise data analysis based on our content-aware networks, it's becoming an important direction for developing value added services. ChinaCache is determined to help optimise the performance and reliability of the Internet infrastructure, enhance the competitiveness of Chinese Internet companies and continuously improve the overall experience of Internet users.

Song Wang: [Mandarin, 22.09–22.45].

David She: Before I turn the call over to our President, Ken Zhang, I want to highlight our announcement earlier today that we have appointed Jing An as our Chief Financial Officer. Jing has been a valuable member of our management team since joining the company in early 2013. During what has been a critical, high growth period for ChinaCache, Jing has demonstrated strong operational leadership and provided strategic guidance on our most important development initiatives. We are very confident in her ability to help manage and direct our future growth.

Song Wang: [Mandarin, 23.21–23.28].

David She: Now, Ken, will discuss technology and operations in the second quarter. Please go ahead.

Ken Zhang: Thank you very much, Mr Wang. I'm very pleased that during the second quarter we continued our growth momentum and achieved the profitability again. This performance reflects our ongoing improvements on operating efficiency and cost and expenses control. We will also continue to strive for progress in many important areas, including R&D, product offering, as well as execution abilities.

Next, I will provide some updates on some important operational highlights. During the second quarter, the number of enterprise customer continue to grow rapidly, increasing 16.6% over the first quarter. Revenue from the Enterprise segment is 12% of company's top line.

As we previously stated, increasing the number of enterprise customers is an important aspect of our growth strategy. As a company in traditional industry such as finance, medical, media, automobile, education and travel embrace the Internet technology, and as the CDN penetration deepens, we believe this customer segment will play an increasingly important role in our business. And we know this generates significant higher margin.

As an example, in Q2, we signed contract with Hunan TV, a traditional TV broadcast service provider, now, distributes its content through the Internet. So the end-user can watch same video content either from the TV screen or from iPhone and iPad. ChinaCache provides total network service to ensure a good end-user experience.

Total video business is growing rapidly, as Mr Wang said, with our bandwidth increased more than 20% over the last quarter. During the second quarter, we also continue our focus on improving internal operational efficiency, in particular, cost of structure optimisation, bandwidth resource optimisation.

ChinaCache relies on its nationwide service nodes to provide content delivery. And in the beginning of the year, we are consolidating, rebuilding and optimising all our service nodes into a portfolio of large, medium and small nodes. The upgraded large and medium nodes will result in higher flexibility and higher redundancy and hence, a better delivered capacity. This will also lower procurement costs and a more efficient bandwidth usage.

The small service nodes will ensure geographic coverage and service failure backup. We are in the process of this restructuring programme and we expect its full operation by end of 2014. It should reduce in percentage of our cost of sale in longer term.

In the second quarter we participated in the credible Cloud Conference and were awarded the Credible Cloud Certificate. This certification is the only official certification in the cloud computing business and has provided a foundation for the entire cloud computing ecosystem in China. In essence, cloud computing is large scale data processing and high I/O throughput based on cloud infrastructure. Apart from all the storage and computing needs, the high I/O throughput are distributed making CDN an integral part of the public cloud. From another perspective, the public cloud service providers are also helping educate the market and enhance the penetration of CDN service in China.

With our nationwide CDN network, our content awareness network is capable of generating and analysing a huge quantity of valuable data. This will drive our value-added service in the future. For example, we conduct analysis of network performance and analyse the behaviour statistics of Internet users.

During the second quarter, we were selected by media portal such as CNTV, Beijing TV Station SOHU, and LeTV for both live streaming and on-demand replay of the World Cup series.

In addition, we also use our CC Index Big Data platform to analyse Internet traffic and monitor data to measure the most active region and the most watched team and the most active moments. The level of data analysis capability will be our foundation for developing a series of value-added services.

During the second quarter, we were also selected by JD.com to support its 18th June Shopping Festival. We successfully enabled JD.com to withstand several service-request storms during 10.00, 22.00 and the 00.00 peaks, thereby ensuring a smooth page view, ordering, and the payment process.

I would also like to mention the opportunity that the booming mobile Internet has created for us. Based on market research, mobile Internet user reached 652 million in China by end of 2013. Furthermore, adoption of 4G LTE technology and the innovation in mobile application creates even greater pressure on the backbone of telecom infrastructure. These require CDN to play an even bigger role in smart dispatching to alleviate pressure of the backbone system.

Our strategy includes: first, working with equipment supplier such as Nokia and Ericsson to store more and more content inside the mobile networks, including radio base station; second, we used CDN technology together with Big Data and cloud computing to analyse user behaviour and then optimise the entire network.; third, we optimised the presentation of mobile content based on perceived end-user device, which creates a bottleneck in the last mile.

In addition, in order to capitalise on the booming 4G business, ChinaCache is exploring potential opportunities to cooperate with business partners and leverage on their different technologies. During our GCDN Conference in second quarter, ChinaCache signed a strategic

framework agreement with Inmobly, a US-based mobile Internet solution provider to jointly develop a mobile service platform specifically addressing the business environment in China and the key demand of the end-user. We will focus on video application and believe this product has significantly improved mobile end-user experience.

There's intensive discussion about SDN and future Internet developing in China. ChinaCache has been invited to participate a number of this kind of forums. We believe CDN is the initial stage of future SDN and our strategy to build content-aware network service will be able to support a fast developing Internet market in China.

I will now turn the call over to Jing, our CFO, to discuss the second quarter financial results. Please?

Jing An: Thank you, Ken. Hello everyone and thank you for your participation. Today my presentation will start with a review of second quarter 2014 results followed by our guidance for the third quarter of 2014. We will then open the call for questions. Please note that the denominating currency is RMB unless otherwise specified.

ChinaCache achieved a strong top line performance during the second quarter with net revenue increasing 34.4% year-over-year to RMB346.3 million from RMB257.7 million in the second quarter of 2013. On a sequential basis, revenue in the second quarter increased by 6.9% over the first quarter of 2014.

We beat our original guidance by 0.4% as we showed stronger-than-expected business, with particular strength in the media & entertainment and enterprise verticals, each increased by one percentage point of revenue.

Second quarter gross margin was 30%, decreasing by 0.3 percentage point from 30.3% in the first quarter. Bandwidth and co-location charges were in line with other revenue growth. The slight decrease in margin mainly reflected the increase of labour costs and other costs as other operating expands.

In the second quarter, we achieved operating income for – of RMB1 million compared to the RMB0.2 million in the previous quarter. Non-GAAP operating income which excludes the share-based compensation expenses was RMB4.1 million compared to RMB3.7 million in the previous quarter and a non-GAAP operating loss of RMB3.7 million in the second quarter of 2013. We are very pleased that with our strong top line growth, we have maintained strict control over operating expenses throughout the company.

Looking at operating expenses, our general and administrative expenses of the second quarter were RMB37.5 million or 10.8% of net revenue compared with RMB37.2 million or 11.5% of the net revenue in previous quarter. The decrease in general and administrative expenses as a percentage to the revenue was primarily due to the economy of scale as our top line expands.

Sales and marketing expenses as a percentage of revenue were 10.2%, flat compared to 10.1% in the prior quarter. Sales and marketing expenses in RMB increased by 8.2% to RMB35.4 million in Q2 from RMB32.7 million in Q1 is mainly due to hosting of the global CDN conference in June.

R&D expenses for the second quarter were RMB30 million or 8.7% of net revenue compared with RMB28.2 million or 8.7% of net revenue in the prior quarter. We continue to remain

dedicated to our research and development efforts as our long-term growth driver and expect the R&D cost to remain stable.

Our total operating expenses were RMB102.9 million or 29.7% of revenue compared to RMB98.1 million or 30.3% of the revenue in the prior quarter. This decrease of percentage weight reflects our commitment on controlling expenses and the improving of our internal operating efficiency.

Looking at the bottom line, I'm very – I'm very pleased with our performance for the second quarter. After a solid first quarter, we realised the profits again in the second quarter with adjusted net income reaching RMB11.6 million compared to RMB2.7 million in the prior quarter. Adjusted net income is defined as net income before share-based compensation expenses, foreign exchange loss or gains and penalties from uncertain tax positions.

Our GAAP net income in the second quarter was RMB6.9 million compared with RMB6.3 million in the first quarter. Our non-GAAP diluted earnings per ADS in the second quarter were RMB0.44 – RMB0.40 compared to RMB0.11 in the first quarter. GAAP diluted earnings per ADS in the second quarter were RMB0.26 compared to RMB0.25 in the first quarter.

Adjusted EBITDA were RMB28.5 million in the second quarter, an improvement of about 12.1% from RMB25.4 million in the prior quarter. Adjusted EBITDA margin for the second quarter was 8.2% versus 7.9% in the prior quarter. Adjusted EBITDA is defined as EBITDA excluding share-based compensation expenses and foreign exchange loss or gain.

I will conclude my portion of today's call with our third quarter guidance. We expect our revenue to be between RMB375 million and RMB380 million representing 36.2% to 38% growth over the third quarter of last year and 8.3% to 9.7% growth over the previous quarter.

In conclusion, I want to emphasise that our results and our guidance demonstrated our commitment to long-term profitable growth.

Now, let's open the call for questions. Operator, please go ahead for the Q&A.

Operator: Thank you. At this time, I would like to remind everyone that in order to ask a question, please press * and then the number 1 on your telephone keypad. Once again, please press * and then the number 1 on your telephone keypad. We will pause for just a moment to compile the Q&A roster.

The first question comes from Kai Qian from CICC.

Kai Qian: [Mandarin, 41.54–43.10]. We have – I have three questions. The first one is about the top line growth. And we are very glad to see the very strong momentum in the top line growth. And any guidance for the, you know, the third quarter this year and the next year and any for example for the top line growth. And my second question is about cost. And the – the cost consolidation in the past previous two quarters pretty good and we – I want to see any guidance for the – on the – on the – for the – looking forward in the Q3 and full-year and any other further, you know, like the cost control in the coming quarter? And then my third question is about the tax, so any guidance about the, you know, the tax in the – in the coming quarter and this year? Thank you.

Jing An: Okay. I'll start with your first question about the – the top line growth. You know – you know, the growth was – the growth was across the board and media and entertainment, which is video mainly – it's from video, enterprise sectors, these two sectors were the main

growth driver of this – of the second quarter and each of the revenue contribution of these two quarters – sorry, of these two sectors increased by 1 percentage point.

So – and we – actually we recently saw a boost in our enterprise business from the media industry as more and more traditional TV stations are using online channels to broadcast their shows.

So to compete with the online video companies, all of these traditional TV stations, they require professional service and solutions from ChinaCache to – to provide an all around guaranteed service user experience for example like flexibility to watch programs online in real time, playback or even just to watch selected clips.

And so in the – I think in the – in the coming quarter or later half of this year the – the, you know, the growth will – still is to be across the board as the Internet traffic in China is growing rapidly and – but most of the – I think that most of the growth is coming from the video, gaming and eCommerce. That's three vertical.

Ken Zhang: Yes. Hi, Kai, it's Ken here. I can adding more. I think as I've said, you know, of the – and Jing said, the traditional industry came in very strong from the beginning of the year and we see more and more. As we've said the traditional TV stations now they are use – use Internet technology and to distribute its content through the Internet. This is – this is changing really, really fast. So we see strong growth there. So we categorise them as the enterprise and the application to video more related to video.

Jing An: Okay. And about your second question about the expenses, OPEX control. You know, we are so happy to see that the OPEX efficiency is continue – gradually improved. And that's mainly from two factors. The first is economy of scale and the second thing is about the better control – cost control. And in the near future and in the long-term, actually a very minor – we're still in the very early stage of this industry and the – the company commit to continually invest for the future growth. So we will – we will try our best to keep the trend and hopefully we can gradually – continually improve the efficiency.

Ken Zhang: Yes. As I mentioned in my part of speech, we have continued restructuring of our service as a whole network, all the service nodes as I said the large, medium, small nodes – service nodes and we actually centralise our purchase – bandwidth purchasing in – in few places and this actually in the longer term we can reuse this bandwidth for all our applications. So this will increase the bandwidth utilisation in the longer term. So as well – I said that by end of the year, this restructuring will be in full completion. So I believe these will further increase the bandwidth usage efficiency, lower the cost of sale part as I've said in my presentation.

Jing An: Okay. In terms of the – your – the – the income tax, there's a fluctuation. As to – as the second quarter of 2013 there is a benefit – is a tax benefit, which is – which is from the true up of the income tax and the second quarter of this year is about the – the deferred tax. So we have – so generally our tax level is stable. So for – for the purpose of the modelling, I suggest 15%.

Kai Qian: Okay. [Mandarin, 48.48].

Operator: Your next question comes from Liping Zhao of CICC.

Liping Zhao: Hi. Thanks. Thanks for taking my questions and congratulations for a strong quarter. I have two questions. The first one is related to the so-called big node project. Has the project completed by Q2? And can we expect to see improvements on the gross margin going forward because I suppose we will have less bandwidth cost and less depreciation cost? And what will be the other impacts on the company operations and that – this is my first question and I'll have a follow-on question later.

Jing An: Okay. In terms of the – the resource management system, which we call it super node system and by the end of the second quarter, about – we finished half of the progress. And now 50% of CDN traffic goes with the new system, which help us – compared with the first quarter help us save bandwidth cost by 1 more percentage point. So – so we will see – in the near future, we'll see – see the benefit.

Ken Zhang: Yes, the improvement will come in gradually and of course we have much higher ambition there.

Liping Zhao: Okay. Thank you. My first question – my second question is related to the cooperation with China Telecom. As Mr Ken – Mr Song Wang mentioned that there are over 1,000 CT employees have finished the training. I'm wondering whether we have seen any revenue from the CT Corporation so far. And Ken mentioned earlier that the enterprise – number of enterprise clients increased over 16%. So I'm wondering whether there are any like clients from the CT Corporation as well or there are only like organic growth.

Song Wang: [Mandarin, 51.08–51.34].

Liping Zhao: Okay. Thank you very much. That's all my questions. Thank you.

Song Wang: David.

David She: Liping, I will translate for Mr Wang's remarks on your question about China Telecom. So the cooperation we believe right now is still at the early stages of training and – and preparation and construction. So right now we – we don't have revenue contributions, significant revenue contributions. And we believe we will gradually see the revenue coming from this cooperation commencing in the fourth quarter. Thank you.

Operator: I would like to remind everyone that in order to ask a question, you may do so by pressing * and then the number 1 on your telephone keypad. I'm showing that there are no further questions. Ladies and gentlemen, do you have any closing comments?

Ken Zhang: Okay. So I will do the conclusion. I thank – in conclusion, I want to thank all our employees who helped to deliver the great quarter and all our shareholders and partners for their continued support. There are a lot of promising opportunity in this fast growing industry. We are very excited for our prospect in 2014 and we are making significant progress in all our business segments including enterprise, mobile internet technology. At the same time we continue to focus on our delivery – deliver a healthy and robust financial and leading the company to a long-term profitability and growth. Thanks for your time today and we're looking forward to seeing you on your – on our next quarter call. Thank you.

Jing An: Thank you everyone.

Operator: That concludes the ChinaCache second quarter 2014 earnings conference call. You may now disconnect.

[END OF TRANSCRIPT]