THOMSON REUTERS

EDITED TRANSCRIPT

Q1 2019 GDS Holdings Ltd Earnings Call

EVENT DATE/TIME: MAY 14, 2019 / 12:00PM GMT

CORPORATE PARTICIPANTS

Dan Newman *GDS Holdings Ltd - Chief Financial Officer*
Laura Chen *GDS Holdings Ltd - Head of Investor Relations*
William Huang *GDS Holdings Ltd - Founder, Chairman and CEO*

CONFERENCE CALL PARTICIPANTS

Jonathan Atkin *RBC Capital Markets - Analyst*
Michael Wang *Cowen and Company - Analyst*
Robert Gutman *Guggenheim - Analyst*
Frank Louthan *Raymond James - Analyst*
Colin McCallum *Credit Suisse - Analyst*
Yang Liu *Morgan Stanley - Analyst*

PRESENTATION

Operator

Hello, ladies and gentlemen. Thank you for standing by for GDS Holdings Ltd. first quarter of 2019 conference call. At this time, all participants are in listen-only mode. After management's prepared remarks, there'll be a question and answer session. Today's conference call is being recorded. I'll now turn the call over to your host, Miss Laura Chen, Head of Investor Relations for the Company. Please go ahead, Laura.

Laura Chen ***GDS Holdings Ltd - Head of Investor Relations***

Thank you. Hello, everyone. Welcome to the 1Q 2019 earnings conference call of GDS Holdings Ltd. The Company's results were issued via newswire services earlier today and are posted online. A summary presentation, which we will refer to during this conference call, can be viewed and downloaded from our IR website at investors.gds-services.com.

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

Before we continue, please note that today's discussion will contain forward-looking statements made under the Safe Harbor provisions of the US Private Securities Reform Act of 1995. Forward-looking statements involve inherent risks and uncertainties. As such, the Company's results may be materially different from the views expressed today. Further information regarding these and other risks and uncertainties is included in the Company's prospectus, as filed with the US SEC. The Company does not assume any obligation to update any forward-looking statements, except as required under applicable law.

Please also note that GDS's earnings press release and this conference call include discussions of unaudited GAAP financial information as well as unaudited non-GAAP financial measures. GDS press release contains a reconciliation of the unaudited non-GAAP measures to the unaudited most directly comparable GAAP measures.

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

William Huang ***GDS Holdings Ltd - Founder, Chairman and CEO***

Thank you, Laura. Hello, everyone. This is William Huang. Thank you for joining us on today's call. We started 2019 right where 2018 left off, with robust growth that translated into strong first quarter results across our business. Demand remains as strong as ever. In the first quarter, we signed up customers for over 16,000 square meters of net additional area committed, which exceeded our own target. We are now halfway through the second quarter and it looks very good.

Maintaining resource supply in Tier 1 markets is a critical success factor. Since the beginning of this year we made significant progress in securing additional land and power for hyperscale development and initiated five new projects. We continued to deliver operationally, resulting in over 60% service revenue growth and over 110% adjusted EBITDA growth, year-on-year. Our margins are expanding even faster than we expected. We crossed the 50% threshold for NOI margin, and our adjusted EBITDA margin hit 43%, an improvement of over 10 percentage points in one year.

We removed the capital overhang by successfully raising around US$595 million of proceeds from the follow-on offering and strategic investment by Ping An. We now have sufficient equity capital to cover our expansion plans for the foreseeable future.

During the first quarter, our new business totally around 30 megawatt, including four deals with hyperscale customers for over 5 megawatt each. Three of the deals were with existing customers, and one of them was with a new customer, a global Cloud leader which is doing very well in China. We now have every single hyperscale Cloud service provider, including the top two global players, and nearly all the major domestics ones present in our data centers, giving us a unique strategic position.

We continue to add Cloud PoPs. AWS Direct Connect and Microsoft ExpressRoute are now living inside several of our data centers, further strengthening our position as Home of the Cloud. We have a good track record of winning business from foreign Cloud players. If the China market opens up, there could be more opportunities for us.

Enterprise customers accounted for 10% of our new business last quarter. We won several notable new logos, including one of the largest auto companies in the world, and one of the largest international hotel groups. We also won sizeable follow-on orders from one of the biggest banks in China and from the leading card transaction platform.

To finish off on demand, I'm often asked about how the macro situation is affecting us. The first thing I would say is that this has been going on for nearly a year, during which time we have continued to rack up impressive sales growth. We are enabling the expansion of the digital economy in China. It's a secular growth story. We have highlighted over the past few quarters how our strategic customer base is becoming more balanced and diversified. We are tapping into more sources of growth. We have set appropriate expectations and we are well on track to achieve our sales target for this year.

Our focus continues to be on Tier 1 markets, where customer located their latency sensitive data. New technology trends are multiplying data volume. At the same time, government policies are making it more and more difficult for data centers to obtain the sufficient power supply where it is needed.

To deal with this challenge, we are evolving our resource strategy. We continue to add data centers in the key cities wherever we can. Since the beginning of the year, we initiated another four organic projects plus one acquisition which we are announcing today. At the same time, we have been working on securing large greenfield sites, on the border of the cities, where we can develop much larger scale.

This is a long and a complicated process, as it must work for our customers, for power, for network, and for the local governments. I'm happy to report that these efforts are yielding significant results. I will focus today on our position in Beijing and Guangzhou. I will update you on Shanghai, Shenzhen and other potential markets on subsequent calls.

Starting with Beijing. During 2018, we initiated four new projects in the city and in 1Q 2019 we initiated one more, Beijing 8. We believe that our city data centers will become increasingly valuable over time, and we are looking at all options to expand our portfolio.

Most of our Beijing data centers are in Daxing district, southeast Beijing, which is a premier data center hub. Langfang is an area adjacent to Daxing in Hebei Province. It is already a well-established data center location serving the Beijing market, with good network connectivity and power infrastructure. Given the constraints, we see demand moving to Langfang, and are positioning ourselves accordingly. Our major customers endorse this strategy.

As the first step, we leased two buildings in Langfang. The first, Langfang 1 is already under construction and fully pre-committed. A few weeks ago, we entered into a framework agreement with the Langfang local government for the acquisition of a large greenfield site and the allocations of significant power capacity. We're now in the formal process for the transfer of land use right. With the addition of Langfang supply, we are strongly positioned in the Beijing market.

Now we talk about Guangzhou. Guangzhou was initially a slower market than Shenzhen, in terms of the data center development, however, as power supply has become extremely limited in Shenzhen, we see demand shifting to Guangzhou. We have a data center cluster in Huangpu District, where our Guangzhou 1, 2 and 3 are located.

Today we are announcing the acquisition of another project in the same area, Guangzhou 6. During 1Q 2019, we initiated a new project in the Nansha District of Guangzhou. Nansha is a major logistics and IT hub which complements our Greater Bay Area presence. The project consists of two buildings, the first of which, Guangzhou 4, is under construction.

We previously disclosed that we have acquired a greenfield site in Guangzhou which will be handed over to us at year end. Talking all together, we are well positioned to capture demand in Guangzhou.

Outside of Tier 1 markets, our customers also require large capacity for what we call cold data, which can be located in lower-cost remote areas. We are starting to see demand from a few of our customers to outsource this as well. Last year, we built three data centers in Hebei which belong in this category.

Going forward, we would like to do more projects like this, because it's important for customer relationships and, with the right structure it can enhance our return on capital. We have therefore been working for quite a while on developing a joint venture structure at the project level which enables us to bring in outside capital from partners.

We are making good progress. We have a world-class financial partner lined up. We will keep you updated on progress. With that, I will hand over to Dan for the financial and operating review.

Dan Newman ***GDS Holdings Ltd - Chief Financial Officer***

Thank you, William. Starting on slide 12, where we strip out the contribution from equipment sales, and the effect of FX changes. In 1Q 2019, our service revenue grew by 7.5%. Underlying adjusted NOI grew by 10.8%, and underlying adjusted EBITDA grew by 14.2% in consecutive quarters.

Our underlying adjusted NOI margin reached 51.3%, and our underlying adjusted EBITDA margin hit 42.5%, which is 9.5 percentage points higher than a year ago.

Turning to slide 13, the main driver of revenue growth was the increase in area utilized, with over 9,700 square meters added in the first quarter. 1Q is seasonally slow because of the cycle around Chinese New Year, and we expect the moving cadence to pick up throughout this year.

Monthly revenue, or "MSR" per square meter, decreased by 0.8% quarter-on-quarter, which is consistent with our expectations for the full year. Some of the decrease was due to lower power usage during the cold months.

Slide 15 shows the strong quarterly trend in margin improvement at the NOI and EBITDA levels. As illustrated on slide 15, the split between stabilized and ramping-up data centers stayed at around the same as for the prior quarter, but the utilization rate for ramping-up data centers in 1Q 2019 was higher.

On slide 16, you can see that most of the improvement in NOI margin came from operating leverage on rent, labor, and other costs. Our stabilized data centers achieved over 55% NOI margin in the quarter. Across the whole portfolio, we're expecting 1 to 2 percentage points further improvement in NOI margin over the next few quarters.

We've been steadily realizing operating leverage on SG&A, which is reflected in the EBITDA margin. Here again, we're expecting at least 1 percentage point further improvement through the year.

Turning to our CapEx on slide 17. We've paid RMB834 million in 1Q 2019, and it should step up in the next few quarters. In our CapEx guidance for 2019, we mentioned that the budget for land acquisitions was around RMB500 million. The Guangzhou and Langfang sites account for less than half.

The new data center acquisition in Guangzhou, Guangzhou 6, is at a total enterprise value, including cost to complete, of RMB550 million. We believe that this data center can achieve a stabilized annual NOI of over RMB80 million. We target closing the acquisition in 3Q 2019 subject to conditions around the property lease and power activation. We're working on other potential M&A deals, and we hope to announce one more quite soon.

Looking at our construction program, we have one data center, Beijing 4, coming into service in the current quarter, and most of the capacity will be committed by then. Across our top three markets, we are well positioned in terms of available capacity under construction relative to our sales targets and demand.

As at the end of 1Q 2019, we have around 227,000 square meters of total capacity in service and under construction, excluding third-party data centers, with a total IT power capacity of 463 megawatts. Our total development cost to date and to complete for this capacity is around RMB15 billion. The unit cost for this capacity works out at just under RMB66,000, or $10,000 per square meter, and RMB32,000, or $4,800 per kilowatt.

Going back to 1Q 2017, our unit cost per kilowatt was RMB35,000. As you can see, it has declined by 8% on a cumulative basis over the subsequent 8 quarters. For the new projects which we are undertaking, the unit cost per kilowatt is typically around RMB30,000.

With regard to financing on slide 18, following the equity issuance in 1Q 2019, our net debt to last quarter adjusted EBITDA multiple has come down dramatically to 4.9 times. Our approach to capital structure remains targeting 60/40 debt to equity at the project level. In our models, this shows leverage going up again for a few quarters to over 6 times, as we make investment ahead of generating EBITDA. We are comfortable with this, as we always have been.

During 1Q 2019, we obtained RMB2.3 billion, or $340 million, of new debt facilities, including refinancing. The current credit environment in China is very favorable for borrowers like us. We're establishing new relationships with Chinese banks which enables us to diversify our funding sources, and we're getting 8-to-10-year tenors, and the lowest interest rates ever.

For a couple of the facilities that we're working on now, the all-in cost is expected to be less than 6%, compared with an effective interest cost in 1Q 2019 of 6.6%. We're trying to take maximum advantage of this while at the same time, cognizant of our large cash balance, we're looking at optimizing our debt, which includes paying down some loans. It is going to take a couple of quarters to balance this out.

Finally, on slide 19, at the end of 1Q 2019, our backlog had increased to over 81,000 square meters. We currently have around 118,000 square meters which is revenue-generating. The backlog therefore implies that we can grow our revenue-generating space by almost 70% without signing any new customer contracts.

Lastly, we reconfirm the guidance which we provided a couple of months ago. I would note that the quarterly cadence should increase over the year. To repeat what William said, we are well on track to deliver our full-year targets.

With that, I will end the formal part of our presentation, and we would now like to open the call to questions. Operator?

QUESTIONS AND ANSWERS

Operator

Thank you. We will now begin the question and answer session. (Operator instructions).

Our first question comes from the line of Jonathan Atkin of RBC Capital Markets. Please go ahead.

Jonathan Atkin ***RBC Capital Markets - Analyst***

Thanks very much. I wondered if you can talk a little bit about the timelines that you're seeing for customers in terms of move-in. Is that roughly the same, or accelerating, or taking longer? Is there a general trend that you could comment on?

Then, if you could also talk a little bit about your revenue. What's your current revenue exposure to non-Chinese customers, and if you could expand a little bit about the interest level on the part of non-Chinese players to enter the market and potentially become customers of GDS? Thank you.

Dan Newman ***GDS Holdings Ltd - Chief Financial Officer***

Okay, thanks, John. It's Dan here. You know, last year, the total, we call it, net additional area utilized, or move-in, was around 46,000 square meters, and I think you will have calculated yourself that our revenue guidance for 2019 implies a move-in over the year which is significantly higher than that.

In the first quarter it was around 10,000 square meters. From everything we know about our customers' move-in intentions, and what is written in the contracts in terms of contractual delivery schedule, we are well on track to achieve the level of move-in that we're expecting.

I really can't comment more specifically to talk about acceleration or slowdown. Nothing can be read into it. It is as we expected.

On your question about foreign customers, of course we have two of the top global cloud service providers. I prefer to talk about the exposure in terms of total area committed than revenue, because revenue is a lagging indicator, as you know, by around 15 months. So, the top two global cloud service providers, that's, in round numbers, around 5% of our business, and you may have seen that recently, in terms of market share, they both have around 6% market share of the cloud market in China, and Amazon, for example, on their recent earnings call highlighted that they were doing very well in China.

So, I don't think we have any concern about that. Our only concern is to make sure that we are perfectly positioned for their expansion plans.

Other than that, our business with foreign customers is mostly multinational corporations and financial institutions, who typically have very long track records in China, and whose business is very stable. Once again, we have no concerns about that.

Jonathan Atkin ***RBC Capital Markets - Analyst***

Yes.

Operator

Thank you. Our next question comes from the line of Robert Gutman from Guggenheim. Thank you, please go ahead.

Robert Gutman ***Guggenheim - Analyst***

Hi, thanks for taking my question. So, given the new business booked in the quarter and the timing of deliveries, is there any change in the expectation of the MSR for the year, which I think the guidance was for down 5%?

Secondly, was the new strategic customer -- was it one of those two clouds, or was it another entity?

Dan Newman ***GDS Holdings Ltd - Chief Financial Officer***

Hi, Rob, it is Dan once again. I think the MSR trend is exactly as we expected. We know what the capacity is due for delivery this year. We know what the selling price is in those contracts. Sometimes as customers move in, their racks may be empty, there may not be significant or there may not be significant power usage that can affect the MSR.

But a 0.8% decline quarter-on-quarter versus what I commented last time, 5% over the full year, is pretty much in line. Yes, the new strategic customer was one of the two top global cloud players. What I think was significant about it is that as is publicly known, we are hosting a couple of their PoPs in two different markets, but we also won for the first time a large order for their cloud platform.

Operator

Thank you, our next question comes from the line of Frank Louthan of Raymond James. Please go ahead.

Frank Louthan ***Raymond James - Analyst***

Great, thank you. I wanted to talk a little bit about the guidance, was there anything sort of one time helping EBITDA in the quarter which when you do the math it sort of implies that you're going to be above the range if you stay in this range of margins for the year? Maybe tell us why you did not raise the guidance there and how we should be thinking about that.

Dan Newman ***GDS Holdings Ltd - Chief Financial Officer***

Frank, it's a good observation. All I can say is we thought about it. Just I think we gave guidance two months ago so it seems a little bit premature. I would rather wait to see where we are in the middle of the year.

Operator

Thank you. (Operator Instructions). Our next question comes from the line of Colby Synesael, from Cowen and Company. Please go ahead.

Michael Wang ***Cowen and Company - Analyst***

Hi, this is Michael Wang for Colby, two questions if I may. First, how would you compare the visibility you have into your leasing pipeline now versus the same time a year ago?

Then second, based on what you are seeing in the market how should we think about MSR trends in 2020 and beyond? thank you!

William Huang ***GDS Holdings Ltd - Founder, Chairman and CEO***

So I'll answer the first question. I mean the pipeline we still think it's consistently like what we see in the beginning of the year, nothing has changed, and we are still very confident our new (inaudible) will be on track.

Dan Newman ***GDS Holdings Ltd - Chief Financial Officer***

Mike, if we are talking about what we call our city data centers, so we're going to make a comment like for like. The pricing is stable to firm I would say which reflects the market situation. We are consistently getting selling price per kilowatt per month net or exclusive of power usage of over US$100, and that's been the case for the last couple of years and remains the case with the deals that we've done very recently.

I can't see anything in terms of dynamic that's going to change in the city data centers, certainly not for the worst. Then of course we have a significant amount of new capacity which will start to come on stream from late next year in the sites that we've started to disclose which are on the borders of the cities. From the very detailed work we have done and the customer interactions we think that we will be able to develop a lower unit cost in those sites.

There may also be some changes in the product mix, it might not all be 2N, which of course has significant implications for the cost. So if that is the case, if either of those are the case, then it will get reflected in the selling price. But the return, as I always say, will remain the same. But I think for modelling purposes it's too early to really build that in in a kind of detailed way.

I think the MSR decline, which we have seen if it is in a city area is really coming to an end. It just has to work its way through over the next four, maybe six quarters.

William Huang ***GDS Holdings Ltd - Founder, Chairman and CEO***

We used to mention that even in Beijing there's such a specific market. I mean the demand/supply it's extremely unbalanced. So what we can see is that in Beijing I mean the price even goes high.

Operator

Thank you. (Operator Instructions). The next question comes from the line of Colin McCallum of Credit Suisse. Please go ahead.

Colin McCallum ***Credit Suisse - Analyst***

Yes, thanks for the opportunity. Just a quick one on this margin issue, it's obviously very strong in the first quarter. I think, Dan, you mentioned a sort of 1 percentage point more throughout the year. Were you referring to on top of the 1Q '19 margin or was that comment more kind of a year-on-year comment in terms of starting points for the margin. That was the first question.

Then a related point, just with margins going up I see you're still obviously making net losses given depreciation and interest charges, but with interest charges also coming down you mentioned, what would be your thinking for when we might be moving to a net profit situation? Is it possible within this year or is it more on next year or a year after situation, thank you?

Dan Newman ***GDS Holdings Ltd - Chief Financial Officer***

Yes, Colin, on margin, first of all, the first quarter margin is not a flash in the pan, it's a data point on a trend line. What I was indicating is that at the NOI level we can see that it will continue to improve. I am not saying every quarter in a consistent way but in terms of a trend by 1 to 2 percentage points I said over the next few quarters.

I don't want to be locked in to say that's exactly what it will be by the end of the year, but there's going to continue to be 1 to 2 percentage points improvement in the NOI margin over the next few quarters. In addition to that, there can be a further 1% improvement due to leverage on SG&A. So if you take those together I was really saying there's 2 to 3 percentage point improvement that we can see with a reasonably high degree of confidence over the next few quarters.

Your question about net income, can I take that offline, Colin, and talk to you one-on-one about that? Not that I'm evading, I just don't know. I think net income will probably not be positive until 2021, maybe the first half of 2021.

Operator

Thank you, our next question comes from the line of Yang Liu of Morgan Stanley. Please go ahead. Yang Liu your line is open, please ask your question.

Yang Liu ***Morgan Stanley - Analyst***

Thanks for the opportunity to ask questions, I have three questions. The first one, can management comment on the valuation multiple in the private market when you do the M&A project, particularly given the credit environment in China get improved? I'm not sure it's the pricing of the M&A deal also got increased.

The second question, could you please elaborate more about how or what kind of advantage helps GDS win orders from the global leading cloud vendors in China? I am sure it's previously used another vendor in China.

The third question is, how about the cloud demand mix in the first quarter? I think management has previous guided for the demand from Tier 2 cloud vendors in China are particularly strong this year. How about the situation now? Thank you.

Dan Newman ***GDS Holdings Ltd - Chief Financial Officer***

Thank, Yang Liu, I'll take the first question on valuation multiples. I am sure you calculated that for what I said the implied multiple for what we call Guangzhou 6 acquisition is probably 7 times or less than 7 times. We evaluate projects from multiple respects but fundamentally our financial approach is always looking at the return on investment.

There is a return target that we require and then that valuation translates into a multiple. So we're not really talking about what is the market multiple. It is hey this is the valuation that we can justify. It just so happens to come at around 7 times in this case.

In terms of the dynamic in the market, we are a cash buyer, I think we have been one of the few if not the only cash buyers for a while and that gives us a special position. I talked before about there being more opportunities. In the past, the competition in terms of - on the buy side has come from Asia, Shanghai, Shenzhen, Stock Exchange listed companies, who try to play a game around injecting data center assets, boosts the valuation as you know very well of tech stocks in China traded at very high multiples.

When the Asia market was down, that created an advantage for us and earlier this year come back up. We did see at least in one situation, the one situation that we are working on, the seller's attention got distracted by the possibility of doing something like that. But then maybe in the last week if there's something positive that's come out of it you can say maybe the softening of the Asia market will put us back in a strong position for M&A. I think that is really all I can comment.

William Huang ***GDS Holdings Ltd - Founder, Chairman and CEO***

Yang liu, let me answer your second question is how we win Cloud from other vendors. I think, number 1, our position is very clear. We focus on the Tier 1 market. We are the only platform player in all the Tier 1 market so that's our focus. So in our sales side, it is our strategy to focus onto getting more of this type of customer in all the Tier 1 market.

It's very strategic because almost every cloud player they want to put their PoPs in all the Tier 1 market, even for now or for the future. So that is very strategic for us, which is our focus. So the win factor is number 1, we are the platform player, number 2, the long-term operational track record and consistent supply in all Tier 1 markets, and we have the experience to serve the long-term customers. So, I think in terms of full service, resource supply, the operation skill, and our ecosystem, these all are the facts that will help bring the customer. In the meanwhile, we win their PoPs in the Tier 1 market. That's our focus.

The third question is that we know there is a lot of the Tier 2 cities demand from the cloud player. This is the new market, as we mentioned a couple of years ago. So, we know this market will be another new market for us. So, we try to do more but in the proper structure and the proper targeted equity partner because if we don't have those kinds of elements, the return is very poor. So now, as I just mentioned, we are almost getting there to set up the right structure with world-class private equity to do this type of data center in the future. From now on, I can say maybe in the next couple of quarters we can do more, we can fulfill more requirements from our existing customers in the Tier 2 cities.

Operator

Thank you. As there are no further questions, I'd like to now turn the call back over to the Company for closing remarks.

Laura Chen ***GDS Holdings Ltd - Head of Investor Relations***

Thank you once again for joining us today. If you have further questions, please feel free to contact GDS Investor Relations through the contact information on our website, or The Piacente Group Investor Relations. Thank you.

Operator

Thank you. This concludes this conference call. You may now disconnect your line. Thank you.