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Q1 2023 GDS Holdings Ltd Earnings Call

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PRESENTATION

Operator

Hello, ladies and gentlemen. Thank you for standing by for the GDS Holdings Limited first quarter's 2023 earnings 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 will now turn the call over to your host, Ms. Laura Chen, Head of Investor Relations for the Company. Please go ahead, Laura.

Laura Chen ***GDS Holdings Limited - Head of IR***

Thank you. Hello, everyone. Welcome to the first quarter 2023 earnings conference call of GDS Holdings Limited. 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 earnings call, can be reviewed 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. Ms. Jamie Khoo, our COO, is also available to answer questions.

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 Litigation 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 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 the call over to GDS Founder, Chairman and CEO, William Huang. Please go ahead, William.

William Huang ***GDS Holdings Limited - President***

Thank you. Hello, everyone, this is William. Thank you for joining us on today's call. Before I review the 1Q23 results, I would like to take a few minutes to highlight our strategic priorities for the next few years. What are we focused on? What are we trying to achieve? These priorities will be benchmarks for tracking our ongoing performance.

The roots of our business are in mainland China, but in the past couple of years, we began to expand overseas. The two regions in which we now operate, mainland China and international, are at different stages of development; therefore, we have set different priorities for each region, in order to achieve the best outcome for our shareholders.

In mainland China, we have grown our business over 20 years, through several distinct phases, to become the leading carrier-neutral data center platform. In the most recent phase of growth, as demand from cloud and internet took off, our priority was to win new business. We achieved an unprecedented level of new bookings, established strategic relationships with all the leading customers and increased our market share.

Our resource strategy was a key success factor. We invested heavily in building up our asset base in all Tier 1 markets, in order to fulfil our customer requirements. Five years ago, we had 20 data centers. Today, we have over 100. We believe it's the largest development program undertaken by any data center company, globally.

In addition to the existing asset base, we secured land and energy quota to maintain continuous supply and grow for many years to come.

Now the market in mainland China is going through a period of adjustment. We are in a new phase and we have reset our priorities accordingly. Our number one priority now is to deliver the RMB6 billion backlog, which is a result of our past sales success. It is sufficient to drive our revenue growth by over 60% over the next few years.

Number 2, as we have already won many years of future business, we will be highly selective in pursuing new orders. We will target opportunities which are strategic, a good fit to our available capacity, a fast-moving schedule, and adequate financial returns.

Number 3, we will prioritise increasing utilization of existing assets. We have a large asset base, both in service and under construction, which is committed by customers, but not yet utilized. As a result, we can deliver the entire backlog with a relatively small amount of incremental CapEx. This enables us to achieve our growth targets, while reducing annual CapEx to RMB2 billion to RMB3 billion going forward.

Number 4, we will only initiate new projects if there is committed demand with confirmed move-in schedule. We expect most of our new projects will be expansion phases of existing sites.

Number 5, building on our success with past waves of cloud and internet demand, we will position our products and technologies to capture the coming wave of AI applications.

For international, our priorities are winning new business, and building market presence.

Number 1, we aim to develop our international business into a second growth engine, which creates significant additional value for GDS shareholders.

Number 2, We will anchor and de-risk our projects with orders from our home market customers as they expand overseas.

Number 3, We will also win significant business from top global customers, many of which are established relationships in China.

Number 4, we will take advantage of our low unit development costs, which comes from our scale, product, and supply chain in China.

Number 5, We will build a standalone business under our international holding company, headquartered in Singapore, while maximizing synergies with GDS mainland China.

In 1Q23, our gross new bookings was around 12,000 square meters, split evenly between mainland China and international. Market demand in mainland China over the past few quarters has been a bit soft. This is mainly because large customers who committed to a scalable capacity will need more time to absorb their inventory. In this environment, as I just explained, we are targeting high quality business, which meets our criteria.

A good example is the [4,600 square meter] (corrected by company after the call) or 9-megawatt order, which we won for Shanghai 18.

The customer is a major Chinese financial institution. The pricing is reasonable, and the underlying asset is an expansion phase of our existing Pujiang campus.

On international side, we won a 6,400 square meters or 26-megawatt expansion order from the anchor customer for our campus in Nusajaya Tech Park, Johor.

You may recall that we are already building three data centers on Site 1, with total IT power capacity of 64 megawatts, which is fully committed by this customer. We started construction less than one year ago, on greenfield land. We are using our prefab design and product, shipped directly from China. We are incorporating liquid cooling for part of the capacity, as required by the customer.

Despite the fact that this is our first project in southeast Asia, we will deliver the first fully powered data center on this site in early 3Q23. We estimate that our unit development cost is 20% lower than the local market. The ability to construct so quickly, and at such a low cost gives us compelling competitive advantages as we expand in the region.

Our gross move-in for the first quarter was around 13,000 square meters, which is consistent with the level of the past few quarters. Our customers are sounding more positive about their business outlook, with new business initiatives and strategic development. As their business picks up, it will flow through to us one or two quarters later, in terms of faster move-in.

To adjust to the current environment, we have slowed down our capacity expansion. In 1Q23 we brought 2,700 square meters of new capacity into service. Over the rest of the year, we plan to bring a further 57,000 square meters into service, split between mainland China and international. All of this capacity has solid customer commitments and confirmed move-in schedules.

As a result of our efforts to adjust the pace of development, our utilization rate has gone up from 67% to 72% over the past year. At the same time, our backlog for area in service has come down from 136,000 square meters to 110,000 square meters.

Our mainland China business is going through a three-year journey to achieve our goals. We are making progress quarter by quarter. We have already done the difficult part, which is to win high quality new business, and secure scarce resource. Now, it's all about execution. Please stay a little patient and watch us deliver.

Our international business is at a different story. There is a great market opportunity on our doorstep, and we know how to win. I'm excited about the prospects for us to create second GDS.

Before I hand over to Dan, I would like to make a few comments about my personal position. After we published the AGM notice a couple of weeks ago, I acknowledge that investors have a number of concerns. GDS was born out of my vision more than 20 years ago. I have built an exceptional team, which has been a major success factor. For me, leading GDS is about much more than just a financial gain. It is driven by a passion to create something extraordinary. This dedication remains unwavering, and I assure you that nothing has changed in this regard.

I want to take this opportunity to address these concerns and emphasize my commitment to our Company. I intend to purchase approximately 1 million ADSs, and possibly more, over the next 12 months, if I am able to do so. In addition, if the AGM proposal is passed, I commit to sustaining my ownership percentage about the new threshold.

I firmly believe that our current share price does not reflect the true value of our Company. I have complete confidence in our ability to enhance our business performance and achieve sustainable growth, thus create significant value for our shareholders.

Now, I will pass on to Dan, for financial and operating review.

Daniel Newman ***GDS Holdings Limited - CFO***

Thank you, William. I would like to start by talking about our financial objectives, which mirror what William said about our business priorities.

For mainland China, Number 1, we target to grow adjusted EBITDA at a mid-teens percentage CAGR, by delivering the backlog.

Number 2, we will become free cash flow positive, by which I mean, free cash flow before financing, within three years. There's already high visibility as to how we will achieve this goal.

Number 3, we will cap net debt at around current levels, and target deleveraging to below 5 times net debt to adjusted EBITDA.

Number 4, we will monetize assets to the extent required to recycle capital and keep within these financial parameters.

Number 5, we will sustain project level unlevered post-tax IRRs of 10% to 13%, by keeping discipline about new business and resources.

For international, 1, we will pursue a low-risk investment strategy, based on firm precommitments.

2, we will target the same investment returns on a portfolio basis as we do for mainland China.

Number 3, we aim for international to contribute over 10% of our consolidated adjusted EBITDA, within three years.

Number 4, we will take a segregated approach to financing, raising external equity and debt on a dedicated basis, and not rely on the capital reserves of GDS Holdings.

Number 5, lastly, we will create additional value for GDS shareholders in a way which is measurable and helps our share price.

Now, I'll talk through our financial performance for the quarter. Turning to slide 20, where we strip out the contribution from equipment sales and the effect of FX changes. In 1Q23, our service revenue grew by 0.2% and underlying adjusted EBITDA grew by 6.6%, quarter-on-quarter.

Turning to slide 21, net additional area utilized during the quarter was 6,085 square meters. As we disclosed previously, a large customer is redeploying around 17,000 square meters from our data centers in Beijing to two of our campuses in Langfang, Hebei Province. The move-out impacts us for the first three quarters of this year. Thereafter, the customer will move into the new locations over about six quarters. In totality, there will be a net increase of area utilized by this customer but with a timing difference.

If we add back the churn in 1Q23, the underlying move in rate was similar to previous quarters at around 12,600 square meters. We expect gross additional area utilized to continue at these levels in 2Q23 and 3Q23 and then to step up significantly in 4Q23 as we have contracts with faster move in.

Monthly service revenue per square meter was RMB2,149 in 1Q23. We expect MSR to decline by around 4%, comparing the final quarter of this year with 4Q22.

Turning to slide 22. For 1Q23 our underlying adjusted gross profit margin was up on the prior quarter by 1.4 percentage points and our underlying adjusted EBITDA margin was up by 2.8 percentage points. At the GP level, this was mainly due to seasonally lower utility cost. At the EBITDA level, there was also some savings in SG&A.

Our profit margins are going to fluctuate over the course of this year. Our guidance implied around 45%, full year adjusted EBITDA margin at the mid-point which has not changed.

Turning to slide 23. In 1Q23, our organic CapEx in mainland China was around RMB1.4 billion and international CapEx was RMB600 million.

Looking at our financing position on slide 24. At the end of 1Q23 our net debt to last quarter annualized adjusted EBITDA ratio was 8.1

times. If we add back the cumulative investment in international at around RMB5 billion or $700 million, the ratio is below 7 times. Our effective interest rate for 1Q23 dropped to 4.3%.

In January of this year, we issued a $580 million CB. As a result, our cash balance increased to RMB10.2 billion or $1.5 billion at the end of the first quarter. In a few days from now, we expect to repurchase $300 million of an existing CB when it is put, which will leave our pro forma cash position at around RMB8.2 billion or $1.2 billion.

Over the remainder of 2023 we have RMB2.4 billion of project loans to repay. We expect to drawdown a similar amount of new project loans.

Looking further ahead, in 2024 we have RMB3.6 billion of project loans to repay. However, as a result of refinancing, which we are currently working on, we expect to reduce this number to RMB2.1 billion. Once again, in 2024, the amount of debt repayment will be more or less equal to the amount of new drawdowns.

Looking at our capital structure plan for mainland China on slide 25. As I mentioned, we target to cap net debt at around current levels over the next three years. We will, in effect, finance new investment through a combination of operating cash flow and asset monetization to the extent required. Our operating cash flow will strengthen with higher asset utilization and reduced input VAT as a result of lower CapEx.

To give an update on the China Data Center Fund, we have signed a limited partnership agreement with the investor. We are now in the process of refinancing the first project, which we intend to inject into the fund. We expect to receive the net cash proceeds from the fund of RMB1.45 billion on completion of the first asset injection in the middle of this year.

Turning to slide 26 for international. We currently have six data centers under construction, two in Hong Kong and four in Johor. The portfolio totals over 120 megawatts of IT power capacity with over 100 megawatts of customer commitments.

The cost to date is around $700 million, which we have financed with around $400 million of paid-up capital and shareholder loans and around $300 million of external debt. We have already put in place long-term term loans for all of these projects.

As I mentioned previously, we intend to raise additional equity externally, either at the project, country or international HoldCo level. We will pursue these options over the remainder of the year.

Turning to slide 27. We confirm that our guidance for FY23 revenue, adjusted EBITDA and CapEx remained unchanged. We'd now like to open the call to questions. Operator, please.

QUESTIONS AND ANSWERS

Operator

Thank you. (Operator Instructions) Our first question comes from Gokul Hariharan from JP Morgan, your line is open.

Gokul Hariharan ***JP Morgan - Analyst***

Yes hi, thanks to William and Dan for comments. My question is on the new targets in China in terms of delivering the existing backlog. Could you talk a little bit about what is the time horizon? Is it in the three-year period that you expect to deliver this backlog? What are you hearing from your existing customers in terms of the ability to shorten the kind of time to move-in from contract for some of this backlog?

Maybe also if you could talk a little bit about where would you get to EBITDA margins? Are you going to stay at similar levels for EBITDA margins in the China business? Or do you see a higher level as we move into a harvest mode for the Chinese market? Thank you.

Dan Newman

Yes, thank you, Gokul. Let me clarify the financial targets. So the base year is 2023 and for most of the financial targets, we're talking about three years, plus or minus a few quarters.

So for the mid-teens EBITDA CAGR for free cash flow positive, deleveraging to below 5 times and incidentally net income positive, we're talking about three years. For the delivery of the backlog, we didn't put a timeframe on that because it's a little bit meaningless as we've still had some new bookings to be added to that. So it's a continuous process of adding new bookings and delivery.

But this year, I think on a net basis with the churn that we talked about, the net additional area utilized will be around 50,000 square meters. But next year we expect that number to be probably 20,000 square meters higher than that. That's our business plan base case.

Do you want to talk about in the more short term, what we're seeing in the move-in, William?

William Huang ***GDS Holdings Limited - President***

Yes, I think it's too early to say this will have a lot of positive will affect today's -- this year's revenue. But we do see some positive signal from the market. I believe you are aware our largest customer, they currently announced that they will split their cloud business and also will target to list in any market, right. So in next 18 months, this is very positive for me. I think this is.

Also, China number one, number two, number three cloud all cut their selling price. Which also means they start to pursue market share. It's not like last year or last two years, just pause the business plan.

That means very clear signal to pursue market share again. So I think it will definitely impact our move-in. But so far, I think their whole sentiment's totally changed but not affect our current - it's too early to say it will affect our current move-in. But I do believe it will affect our next year or next two- or three-years' move-in schedule.

I wish, and maybe it's possible, they will bring the move-in schedule more early.

Dan Newman

I just wanted to finish off and talk about the EBITDA margin expectations. I think, once again, referring to a three-year target. I'd say we're looking for at least 2 percentage points higher EBITDA margin than we achieve in FY23.

Gokul Hariharan ***JP Morgan - Analyst***

Got it, that's very clear, thank you. Thanks Dan and William.

Operator

Thank you, one moment for our next question. We have a question from Jonathan Atkin from RBC. Your line is open.

Jonathan Atkin ***RBC - Analyst***

Thanks. You talked a little bit about synergies that you'll be getting in your international operations from China and I think you talked a little bit about shipping some of the equipment into Malaysia. Can you talk a little bit more about whether it's revenue synergies or backlog or operating synergies or other types of benefits that you will get between the core Chinese company and then offshore.

Then secondly, I was interested in the demand profile that you're seeing internationally. Different demands dynamics. I think you've got fairly kind of single threaded demands at least currently in Johor. And what does the prospective kind of sales pipeline look like internationally? Is it Asian, is it Western customers? Maybe a little bit more color on that. Thank you.

William Huang ***GDS Holdings Limited - President***

Hey John, this is William. I think let me talk about the synergy between international business and the mainland China business. I think it's very obvious we can leverage our current product and supply chain and customer platform. This is quite unique, which I don't think the other players in this region have this kind of advantage. So I think that's why we are very confident, based on our current advantage, we will follow-up our customers, we will follow-up with a successful product in China, which I think is still a fully well-developed product.

Also, the supply chain is very important as well. I think because GDS already reached the point which we always do, we're the largest builder in the world in the last couple of years. I think this gives us a very unique position to get a much cheaper supply chain.

The pipeline, I think it's in the situation that everybody talks about Southeast Asia, which is true, Southeast Asia has a huge demand. Because if you look at a Chinese customer or a US customer, they all announced big plans in this region. So this is not just an announcement based on what's our dialogue between GDS and all our customers. We do have the real demand in this region.

So in terms of pipeline, for us I think we still remain a very strong pipeline from China and also US customers. Again, I say we also see some domestic demand.

Jonathan Atkin *RBC - Analyst*

Thanks very much.

Operator

Thank you, one moment for our next question. We have a question from Frank Louthan from Raymond James. Your line is open.

Frank Louthan *Raymond James - Analyst*

Great, thank you. As you look forward, what percentage of your installs and sales do you think are going to be AI-related? Can you characterize the AI demand that you're seeing between the mainland China business and the international deployments? Thanks.

William Huang *GDS Holdings Limited - President*

Number 1, I think in China, I think we see it's a little bit early stage for AI-driven demand but it's happening right now. I think in China, the big platform all already announced -- already announced their AI stuff. But we think it will impact our new booking maybe one year after or two years after. It's a little bit behind what happening in the US, but I think it will happen, so this is in China.

In outside -- international business, we have seen some, let's say, new demand configuration, it's more AI-driven. So let's say I already mentioned in our Southeast Asia data center we are really implementing liquid cooling stuff. This is mainly driven by the GPU type of server, so I think this is mainly for the AI stuff. It's happening in Southeast Asia already.

Frank Louthan *Raymond James - Analyst*

All right, great. Thank you very much.

Operator

Thank you, we have a question from Peter Milliken from Deutsche Bank. Your line is open.

Peter Milliken *Deutsche Bank - Analyst*

Yes, hi, good evening, everybody. My question is about the forward sale. When was that first disclosed? Was it in the 2022 20-F, or had it been announced previously? Because I hadn't heard of it before.

Dan Newman

Peter, it was disclosed at the time. Well, it's not one transaction, but they were disclosed at the time when the transactions were done. The counterparty banks, which incidentally are amongst the largest banks in the world, were required to make disclosures and duly did so, so that was 100% in line with the legal requirements.

At that time, the system employed by the US SEC was that these disclosures were made in so-called paper filings and some institutional investors, I think, subscribe to services who search paper filings and access that information, but as we know now, many do not. As a result, I think quite a few institutional investors are just kind of like relying on Bloomberg or some other terminals were not aware of the disclosure. Ironically, in April of this year the SEC changed their system, so those disclosures would have been made electronically now and it would have been accessible in the usual way.

Peter Milliken ***Deutsche Bank - Analyst***

Right, yes, I'm sure the people who invested in the secondary listing would have liked to have known that. Look, my second question is really about why you wouldn't have prepared the bonds to be ready for this change of control event potentially. You've had a few years where you've been aware of this. Why weren't you talking to them about changing covenants and rolling debt and things like that? Why does it lead to this sudden point where investors have to make a quick decision on agreeing to this change of control event?

Dan Newman

Peter, we operate in an environment where we make very extensive disclosures. In our articles of association, it states that if William's ownership, beneficial ownership falls below 5%, then his Class B shares automatically converted to Class A shares. I think everyone's known that as a risk factor in our 20-F. I think since the completion of our Hong Kong IPO, William's shareholding has been just above that threshold and it could have gone below that threshold for any number of reasons. If we'd issued only a relatively small number of shares in a capital raise, for example, his ownership would have gone below that threshold. So this should be very clearly understood, it's simple disclosure.

We need to make some changes to our articles subsequent to our Hong Kong IPO, it's something that all the companies in our category of US ADR companies with secondary listings have to commit after the Hong Kong IPO to implement certain changes to the articles. So we felt that it would be convenient or appropriate to package together all the changes to the articles at the same time in our annual general meeting, which is what we're proposing to do.

Peter Milliken ***Deutsche Bank - Analyst***

Got it, okay, thank you.

Operator

Thank you, we have a question from Edison Lee with Jefferies Group. Your line is open.

Edison Lee ***Jefferies - Analyst***

Thank you for taking my question. Hi William and Dan, I have two questions. Number 1 is that one of your objectives at the early part of the PPT said that you are trying to shorten the lead time from investment in move-in to less than two years. What is the average period right now and what is your strategy to try to shorten that to less than two years?

The second question is about what percentage of your backlog for area and surface is going to hit that completion of the ramp-up period in the next, let's say within 2023?

Dan Newman

I missed the second part of the question, sorry.

Edison Lee ***Jefferies - Analyst***

The second question is what percentage of your backlog (inaudible).

Dan Newman

Sure, thanks, Edison. William, I'll go first. I think it's a characteristic of quite a scaled business, because the order size is very large, customers need to pre-commit in order for data center companies to develop and they commit for an entire data center. But it's pretty much standard for these contracts to give the customer quite a lot of flexibility over the amount of time that they move in.

I think the cloud service providers, because their requirement is for continuous upscale, I think that they in past planned furthest ahead and maybe their resource plan was three or even more years ahead of time. They, in our experience, habitually took the longest to move in, so the contracts would give them two years and they would actually move in over a two-year period.

Now that has extended to beyond two years, but the internet companies, quite often we see that they were not placing the order so far ahead. Very often the requirement was urgent, maybe because their business was so dynamic and their forecasting was not so well established. So a key selection criteria would be can you deliver in six months' time, can you deliver in nine months' time?

Then while the contract would typically still have a two-year move in period, I would say on average the internet companies move in faster. Maybe they move in more like one year. So you know last year the mix of our business by customer segment changed quite a bit. Cloud, which had been, I think, as high as 70% or even more of our business, was 20% in terms of our new business last year. Then internet was 60% and enterprise was 20%.

I think just that change in itself will lead to faster delivery, but if you look at the totality of our backlog of over 200,000 square meters, well over 50% of that backlog is cloud, so that's why we have to work through the delivery of the backlog but then for the new - what we're targeting now, expect to see a shorter lead time from when the order is booked until the service delivery starts and then a shorter move-in period.

Edison Lee ***Jefferies - Analyst***

Does that mean that you are going to ask for a shorter move-in period, even for the traditional CSP customers? Or do you think you will try to expand customers more into the non-CSP customers?

Dan Newman

Are we going to try to -- I guess - as a contractual term, insist on a faster move-in period for cloud service provider customers?

William Huang ***GDS Holdings Limited - President***

I just mentioned that. Yes, I think the moving parts we expect of course the new bookings -- last year, the new booking mainly driven by the internet companies. I think they're more faster move-in than cloud but the cloud business in the last two years is as I just mentioned is paused their business plan, right? But now they boosted their new business plan right now, but I wish maybe it will happen. Possibly they will move more faster starting from next year. So I'm quite positive for this.

Edison Lee ***Jefferies - Analyst***

Sorry, I just need to ask this follow up. So, does it mean that for new contracts with cloud service providers who actually ask for less than two years move-in?

William Huang ***GDS Holdings Limited - President***

New contract? New contract I think is much faster than two years.

Dan Newman

New contract [wins]. Edison is asking specifically whether the business we do with cloud service providers, whether we will insist on a faster move-in period. Is that right?

William Huang ***GDS Holdings Limited - President***

Yes, I think new contract -- if we have the new contract, that means they have a real demand, so definitely we will ask for more ready to move-in. Otherwise, they still have a lot of their inventory. If we had the new contract from the cloud then that means their demands much stronger than they expect.

Edison Lee ***Jefferies - Analyst***

So can you tell us what are you going to ask, for one year, one and a half year? Is there any particular target that you have here?

Dan Newman

Edison, you're asking about a situation that hasn't arisen yet. We've got more than 50% of our backlog, and the terms already agreed and if you look at the size of our backlog relative to our annual move-in, you'd see it's at least three plus years of new business there, right? I think we already locked in most of the commercial terms for the next three or four years, new business.

Edison Lee ***Jefferies - Analyst***

Okay.

Dan Newman

I think we'll probably see not more than 20% of our new bookings will be cloud going forward.

Edison Lee *Jefferies - Analyst*

So, I guess that is related to my second question, right, because I want to know what percentage of your backlog for area and surface will actually become hit to that ramp-up period because I want to get a sense as to whether you are vulnerable to these completion periods actually being extended, because of slow move-in and how much would that impact your revenue?

Dan Newman

I think it's simple. I provide some formal guidance and direction on what is the annual net add in terms of area utilized. I commented on what we expect to see in 2024 as well, so I'm factoring in what I know bottom-up in terms of what's in those contracts and what we understand about our customers' intentions. Probably a simpler approach is to take my direction because I'm amalgamating a lot of different factors.

William Huang *GDS Holdings Limited - President*

Right, but will there be situations where because it hit the two-year ramp-up period, so even if the capacity or the square meter utilized is below the committed rate, you will be able to charge the full price or that's certainly going to happen?

Dan Newman

Yes, we are able. That's a commercial decision, right? We are able to charge the full price.

William Huang *GDS Holdings Limited - President*

Yes, that's true.

Operator

Thank you. One moment for our next question. We have a question from Yang Liu with Morgan Stanley. Your line is open.

Yang Liu *Morgan Stanley - Analyst*

Thanks for the opportunity. I have one question regarding the MSR on trend. I think Dan just mentioned that you expect a 4-percentage-point drop by the end of this year. I just want to have a better view about how much of that will be driven by the mix change of the Company's new capacity and how much will be driven by potential contract renewal. Because I saw in the back section of the presentation you have around 10% of contracts about to renew this year, so does this MSR change or what is the assumption of the contract renewal in here, behind the MSR drop? Thank you.

Dan Newman

Once again, Yang Liu, this is a bottom-up number which is an amalgamation of the contracts in the backlog which we expect to deliver and the outcome that we're expecting in terms of pricing on contract renewals and a reflected all in the guidance we gave or the direction we gave on MSR, which is a 4Q versus 4Q number. By the way, I'll go further in to say in 2024 we think that MSR decline would be around 2% to 3%.

So, it's simpler to take my direction rather than asking to disaggregate it into all the parts. If you follow what's happening in the US, where we see that pricing is firmer, increasing in some Tier 1 markets in the US and in Europe, we're not in that situation yet in China. We think we may be one or two years behind that.

But even at current levels, our projects give us, we think, reasonable returns versus our cost of capital, so I think the business is very sound at current levels and we will wait over the next one or two years to hopefully see the market situation improve slightly somewhat in our favor.

Yang Liu *Morgan Stanley - Analyst*

Got it. Thank you.

Operator

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

Laura Chen ***GDS Holdings Limited - Head of IR***

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. See you next time. Bye-bye.

Operator

This concludes the conference call. You may now disconnect your lines. Thank you.