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Q3 2023 GDS Holdings Ltd Earnings Call

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William Huang

PRESENTATION

Operator

Hello, ladies and gentlemen. Thank you for standing by for GDS Holdings Limited's third quarter 2023 earnings conference call. At this time, all participants are in listen-only mode. After the management's prepared remarks, there will be the question-and-answer session. Today's conference call is being recorded. I will now turn the call over to your host Miss Laura Chen, Head of Investor Relations for the Company. Please go ahead, Laura.

Laura Chen *GDA Holdings Limited - Head of IR*

Thank you. Hello, everyone, welcome to the third 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 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. 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 risk and uncertainties, as such the Company's results may be materially different from the views expressed today. Further information regarding these and other risk 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 includes discussions of unaudited GAAP financial information, as well as unaudited non-GAAP financial measures. GDS's 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

Okay. Hello, everyone, this is William. Thank you for joining us on today's call. The number one priority of GDS management is to create value for our shareholders and drive share price recovery. We are pursuing this goal by executing distinct strategies for our China and international business.

For China, our financial objectives are to grow EBITDA at a steady rate, maintain positive cashflow before financing and de-lever the balance sheet. We are getting there by, first taking a highly selective approach to new bookings, which match our inventory and come with faster move-in rates. Second, delivering the backlog and increasing capacity utilization and setting a high bar for new CapEx to fulfill orders with firm move-in schedules.

For international, our financial objectives are to create a second growth engine, which enhances our equity valuation. We are leveraging our competitive strengths to build a leading presence in regional hub markets, win landmark commitments from global and China customers and finance the business independently.

Now, let's dive into our progress towards achieving these objectives. In Q3 2023, we won 21,000 square meters or 54 megawatts of new customer commitments, all in China. The two largest orders were from internet companies in the live streaming and the short video vertical, which continues to perform strongly. The orders were for additional capacity at our campuses in Langfang near Beijing, where they have already deployed. The move-in periods are faster than usual. Market demand in China has not yet picked up noticeably, as large customers still have inventory to absorb. The data center market will recover when t is a broad based recovery in the digital economy.

We believe that the AI demand wave is coming. However, it will take more time for customers to further develop their models and applications, adapt to new regulations and solve the chip supply issue. AI will require a lot of data center capacity in Tier 1 markets, which plays to our strengths. When this demand starts to materialize in size, we will be very well positioned.

Since the launch of our international strategy, new bookings from international have made up 40% of net additional area committed. In order to maintain this success, we are putting a lot of effort into securing attractive resource supply, just like what we did before in China.

Our gross move-in for the third quarter was nearly 21,000 square meters, comprising 17,000 square meters in China and nearly 4,000 square meters international. Throughout the current phase of market development, the gross move-in for our China data centers has been sustained at a consistent level. Meanwhile, 3Q23 was the first quarter in which international made a material contribution. We expect the contribution from international to ramp up significantly over the next few quarters.

In 3Q23, we brought around 23,000 square meters of new capacity into service, 13,000 square meters was at two of our campuses in Langfang, China. The capacity is 100% committed to a single customer, which is redeploying from other data centers. The move-in period for this new capacity is faster than usual.

The remaining 10,000 square meters is the first data center at our NTP campus in Johor, Malaysia. This data center is also 100% committed with a move-in period of only a few months.

In 4Q23 we expect to bring another 20,000 square meters into service, half in China and half international. Once again, all of this new capacity is 100% committed, with fixed move-in schedules.

Turning to slide 15, we are making good progress in the execution of our international strategy. Starting with Hong Kong, our first data center, Hong Kong 1, has entered service and is almost sold out to global and China customers.

Our second data center, Hong Kong 2, is under construction. During the current quarter, we expect to secure an anchor customer commitment for Hong Kong 2 more than 15 months ahead of project completion.

Moving to Johor, our NTP campus has 160 megawatts of power capacity across the first three phases, out of which 96 megawatts is already committed. In 3Q23, we delivered 23 megawatts, which is already fully revenue generating. Over the next few quarters, we will deliver the remaining 73 megawatts of committed capacity, which will also become fully revenue generating within a short period of time.

While we still have room for expansion at NTP, we have enhanced our resource supply by acquiring land for a second campus in Johor. We refer to this new site as Kampas Tech Park, or KTP. In the first phase of development, KTP will have 108 megawatts of power capacity.

We are seeing strong demand for our capacity in Johor from global and China customers. We are the only player to have two complimentary locations, both of which are only a few kilometers from Singapore. Across these sites, we have secured 268 megawatts of power supply over the next three years. This gives us time-to-market advantage, an important consideration as customers accelerate procurement to meet AI demand.

Furthermore, we have already proven our execution capability in Johor by deploying our prefab technology, including liquid cooling modules, to successfully deliver hyperscale capacity in just over one year.

In Singapore, following the award of power quota, we are finalizing the site selection for our first data center. We are on track to deliver capacity in 2026.

In Indonesia, we are very pleased to finalize a JV agreement with INA, the Indonesia sovereign wealth fund. We believe that INA will be a great partner for us because of their complimentary strengths, unique relationships and value-add. The JV is for all of our developments in Indonesia. We continue to make progress with our first project in Batam. We are working with INA to put in place the essential infrastructure.

Finally, we are moving forward with the first round private equity capital raising for our international HoldCo. It is going well.

I will now pass on to Dan for the financial and operating review.

Dan Newman ***GDS Holdings Limited - CFO***

Thank you, William. Turning to slide 19, in 3Q23 revenue increased by 6.4% and adjusted EBITDA increased by 5.6% year on year. For the quarter-on-quarter analysis, we have excluded the one-time items which arose in 2Q23, as previously disclosed. On this basis, revenue grew by 4.9% and adjusted EBITDA decreased by 1.4% quarter-on-quarter. The decrease was mainly due to higher utility costs, which I will come to in a minute.

Turning to slide 20, during 3Q23 we achieved net additional area utilized of 16,000 square meters. During the past few quarters, our net add has been affected by higher than usual churn, which is mainly due to one customer's redeployment. This will continue into the fourth quarter; however, we are now seeing the impact partly offset by greater contribution from international.

Monthly service revenue per square meter was RMB2,149 in 3Q23. Compared with the third quarter of 2022, MSR decreased by 4%, in line with our expectations.

Turning to slide 21, due to the seasonal fluctuations in PUE, we think it makes most sense to look at our margin trends by comparing with the same quarter in the prior year. For 3Q23, our adjusted gross profit margin was 49.5%, compared with 50.7% in 3Q22, a decrease of 1.2 percentage points.

During 3Q23, utility cost as a percentage of revenue was 35.1%, compared with 31.6% in 3Q22, an increase of 3.5 percentage points. This reflects increase in power generation and more recently, in power distribution tariffs. However, as you can see, we were able to mitigate some of the impact of higher utility cost with other cost savings.

Adjusted EBITDA margin was 44.7% in 3Q23, which is only slightly down versus the same quarter of last year.

Turning to slide 22, over the first nine months of 2023 our China CapEx totaled RMB3.1 billion. Our full year guidance was for RMB3.5 billion and we still expect to be within that figure. However, next year we expect China CapEx to be materially lower at around RMB2.5 billion.

Over the first nine months of 2023, our international CapEx was around RMB2 billion. Given the rapid pace of development in Johor to meet delivery schedules, we expect ful year CapEx in international to be around RMB4 billion, in line with our guidance. Our preliminary view is that international CapEx will be RMB4 billion or higher next year.

On slide 23, we plan to finance the international business independently. On the equity side, we are undertaking an equity private placement, the proceeds of which will be ringfenced. On the debt side, we're aiming to finance international projects on a non-recourse basis. We should therefore look at our financial position in two distinct parts, GDS Holding excluding international, which is in effect ListCo plus the China business and international standalone.

Over the first nine months of 2023, GDS Holdings excluding international had negative cash flow before financing of RMB1.8 billion. As William mentioned, our objective is to maintain positive cash flow before financing on an organic basis, without assuming any asset monetization. Cash flow before financing for this segment was in fact positive in 3Q23 but it will take another year or so before it is consistently positive quarter after quarter.

International standalone will have negative cash flow before financing of around RMB4 billion this year and potentially a similar amount next year. We can finance this deficit with around 50% equity and 50% debt.

For the equity requirement, we aim to raise at least US$400 million or RMB2.8 billion in the current funding round. We have received very strong interest from regional and global investors and expect to close the capital raise in 1Q24.

Looking at our financing position on slide 24, at the end of 3Q23 our consolidated net debt to last quarter annualized adjusted EBITDA was 8.6 times. Excluding the net debt and negative adjusted EBITDA of international, the multiple was 7.4 times to 7.5 times. If we continue along the same path, the leverage of GDS Holdings excluding international falls to below 6 times within three years.

However, we continue to work on various asset monetization initiatives, including two data center funds, the potential C-REIT and property sale and leaseback. This could enable us to deleverage a bit faster.

Turning to slide 25, we are showing the loan maturity schedule for the first time with the debt of international separately identified. Over the next couple of years, we have, on average, RMB2.7 billion per annum of principal repayments, all of which is onshore RMB project loans.

A large part of this can be refinanced, as we have been doing successfully for many years, although we do intend to use part of our cash balance to pay down some debt where it is prudent and efficient.

Turning to slide 26, we are not changing our formal guidance for FY23 revenue, adjusted EBITDA and CapEx. However, we note that FY23 revenue is tracking to the bottom end of our original guidance range, while FY23 adjusted EBITDA is tracking to the top end of the original guidance range.

QUESTIONS AND ANSWERS

Editor

We'd now like to open the call to questions, operator.

Operator

Thank you. (Operator Instructions) For the benefit of all participants on today's call, please limit yourself to one question. If you have more questions, please reenter the queue. Thank you so much, please stand by while we compile the Q&A roster. This will take a few moments.

Now we are going to take our first question today and it comes from the line of Jonathan Atkin from RBC. Your line is open, please ask your question.

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

Thank you. I wondered if you could remind us of your expectations around renewal pricing and renewal spreads inside of China over the coming year, as well as your overall expectations around the pace at which utilization could increase in your existing campuses. Thank you.

Dan Newman ***GDS Holdings Limited - CFO***

Thank you, Jon. I always prefer to address this question in a more holistic way. We have a KPI of MSR per square meter per month, which reflects a number of different factors, including renewal spreads and changes in the product mix and location. I think this year we said expectation is that it would decline by 4% year on year, which indeed it is doing so.

I think next year it will decline by less than that, our preliminary view is about 2% year on year, which indicates that it's bottoming out. That gives you some indication of what's happening with renewal spreads, although as I say, it does also reflect a number of other factors.

As regards utilization rate, that will increase gradually. It will take about three years to get from where we are today, which is around 71%, 72%, to over 80%. I think we cross 80% during FY26 and then it will take another couple of years to get up into the high 80s.

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

If I could just squeeze in an additional part of my question, KTP, is that a different part of Johor, or is that adjacent to Nusajaya? Maybe you can give us a little bit of color there. Then the demand signals that you're seeing in Indonesia, in Batam, is the JV constrained to Batam or would you look to potentially go elsewhere in Indonesia? Thank you.

William Huang

I think KTP actually is very close to Singapore as well. If you look at it, it's around 10 kilometers from our NTP, right, 10 kilometers. So it's a typical fit for a lot of the hyperscale guys which is cloud guys, or some hyperscale deployment structure. So the good thing, the beautiful thing is that it's very close to Singapore. Latency is not an issue and also very close, 10 kilometers away from our current NTP.

So this is perfect, it can allow a lot of our customer - fit a lot of our customers deploy their IT in Singapore, KTP and NTP. We are working very closely with a lot of potential customers. This structure perfectly fits their future demand.

Batam, we have made a lot of progress in terms of construction and we saw a lot of potential demand on our hands. So currently we are working on a lot of the potential demand, so we believe this is -- sell the Batam is not a big issue for us. So I think now Batam is in a unique position. Number 1, it not only serves the region, they also serve - fully recognized by the Indonesia domestic market.

Also, the power cost is lower than any location in Southeast Asia and potentially the renewable energy will come soon. In the future we will combine renewable energy and low power costs and serve more broad region. This is a very unique position for the whole region, so we are very confident to get a lot of demand for Batam data center.

INA is a very good partner as I mentioned , because they are very active to help GDS set up more advantage in Batam and help us to introduce a lot of renewable energy per year in this region. They help us to find a lot of the potential data center sites in Jakarta as well, so we are very appreciative. They are a real value-added partner. I think in the future they can add more value in terms of bringing us to some SoE customers and also the government's potential demand, so we are looking forward to working more closely with INA.

Operator

Now we are going to take our next question. Give us a moment. The next question comes from the line of Yang Liu from Morgan Stanley. Your line is open. Please ask your question.

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

My question is regarding the move-in outlook, because we see a pretty big delivery of the overseas project in the third quarter. Should we expect starting from fourth quarter or maybe first quarter next year we'll see q-on-q improvement of the move-in speed?

William Huang

Yes, I think you're right. We have very good terms with our overseas customers. I think from Q4 and the next quarter, the ramp-up is -- we are very happy with this ramp-up speed. I think you will see that overseas will contribute more next year.

Dan Newman ***GDS Holdings Limited - CFO***

In the third quarter, net of churn was 16,000 square meters, which is higher than it has been for the last five or six quarters. Clearly, international started to make a contribution there.

I did mention in the fourth quarter there will be another quarter in which there is an exceptional churn, that is the completion of what we've been talking about over the last four quarters. Other than that, I think the net additional area utilized in the fourth quarter, net of that churn, will be higher than what it was in the third quarter. Next year, I expect it will be significantly higher than what it is on a net basis in 2023.

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

Thank you. I just want to make sure that the previous single-customer churn will end in Q4 this year.

Dan Newman ***GDS Holdings Limited - CFO***

That's right. Maybe I could take this opportunity just to give some statistics about churn. We talk about it in terms of square meters of area utilized. It's easier to track it that way. We think that our normal churn rate going forward will be around 4% of area utilized, maybe 4% to 5%, which I believe is low by global benchmarks. In past years it was 2% to 3% but given the evolution of our business it is natural to expect that to be higher.

In the current year, I think the total churn will be around 28,000 to 29,000 square meters, which is around 7.5%, so it is clearly higher, and the difference is what we call exceptional churn. The redeployment is actually the majority of that.

This will happen from time to time, and it can set us back in the short term. It can affect our growth rate by a small amount, but it so happens the redeploying customer has placed new orders with us which are 1.5 times the amount which they've terminated, so in effect it's one step back and one and a half steps forward, albeit with a timing difference.

Hopefully, that will be complete, and hopefully we will revert to what I've described as the normal level of churn.

Operator

We are going to take our next question. Just give us a moment. The next question comes from the line of Frank Louthan from Raymond James. Your line is open. Please ask your question.

Unidentified Participant

Good morning, this is Rob on for Frank. Are you seeing any demand for liquid-cooling-based servers? If so, who pays the extra capital costs required for that? Do you guys pay it and adjust the pricing, or does the customer contribute some capital? Thank you.

William Huang

As I just mentioned, we deployed the -- first of all, I think we already deployed (corrected by company after the call) the liquid cooling a couple of years ago in China. We are very familiar with this technology. I just mentioned we are deploying now NTP1, so our customers also require liquid cooling.

In the future, for the AI guys, this will very normal, but not every AI customer uses liquid cooling. It depends. Different customers have different profiles. But (1) we are very familiar with that; (2) I think in terms of cost, in our view it is not significantly different than what we built before for the normal case. Of course, if costs increase, we definitely will charge our customers. We already have a mutual agreement with our customers, so this will not impact any of our returns.

Operator

Now we are going to take our next question. Just a moment. The next question comes from the line of Sara Wang from UBS. Your line is open. Please ask your question.

Sara Wang ***UBS - Analyst***

Thank you for the opportunity. I have a question on overseas business especially for the Johor campus. Besides China customers, shall we expect meaningful new orders from either international customers, cloud customers or local customers? Especially given there are lot of other data center operators that announced meaningful pipelines in the region, so how shall we think about the competition landscape going forward? Thank you.

William Huang

Number one, we targeting all kinds of customers. Our sales team is working on domestic demand, international demand and also China demand. So we don't care who is the customer. Customer is customer. But we believe our Johor campus, two campuses including new future campus KTP we are (corrected by company after the call) definitely confident to get the combination of the customers, just like what we did in Hong Kong already. So I think this will not be the issue. We will not just specifically target one kind of customer. We target all. We believe GDS's sales and our product will be welcomed by all kinds of customers as well.

In terms of the competition, we have competed with everybody in China for 22 years. We're not afraid of competing. We like competition. At GDS, we will grow from a lot of competitors, so I think it's good. That's why if you -- we already demonstrated even in a very competitive market in China in the last 20 years, and we're getting number 1 position. We are not thinking about what our competitors are doing. They can do everything, but we believe we will win in every market.

Sara Wang ***UBS - Analyst***

Got it. Is there any additional color on the gross new bookings for next year? Should they be higher than this year, especially given that Johor campus continue to ramp up?

William Huang

Do you mean the international market?

Dan Newman ***GDS Holdings Limited - CFO***

Maybe overall.

William Huang

Overall?

Sara Wang ***UBS - Analyst***

Yes, overall and then maybe if there's additional color on overseas contribution.

Dan Newman ***GDS Holdings Limited - CFO***

So actually, we take this in two parts. For China, over quite a few quarters now we've made it clear that we're not targeting a high sales volume. We're targeting a particular kind of business, which matches the inventory that we have, where there's a fixed move-in schedule, faster than what we've experienced before, and of course reasonable pricing. So we do any amount of business that meets those criteria.

We don't forecast any change in China market conditions. Our own internal business plan assumes continuation at the current run rate. We're not crystal ball gazers, so we don't build in any assumptions about change in market conditions. But of course, we are very well positioned to respond to any change.

On the international side, I think the sales next year could be higher than this year. This year, including the second data center in Hong Kong, if we we're able to conclude that pre-sale, pre-commitment during the fourth quarter, then the gross bookings for international will be about 20,000 square meters over the course of 2023. We'd hope to do at least that again next year.

The order size has been very large on the international side. It's hard to predict because one order can make a huge difference. It's not a widely dispersed book of orders but it's a small number of very large orders.

Sara Wang ***UBS - Analyst***

Got that, very clear. Thank you.

Operator

Thank you. (Operator Instructions). For the benefit of all participants, please limit yourself to one question. Afterwards, if you would like, you're more than welcome to re-enter the queue. Thank you.

Now we're going to take our next question. The next question comes from the line of Michael Elias from TD Cowen. Your line is open. Please ask your question.

Michael Elias ***TD Cowen - Analyst***

Thanks for takings the question. I have two, if I may. First on the demand side. As we think about mainland China, would it be possible for you to create or provide a framework for how you're thinking about the evolution of demand in mainland China, specifically You talked earlier about, it seems like there's some digestion that's happening in the market. Could you talk about your conversations with the cloud customers and essentially what it's indicating is driving the slowdown in demand there?

Then, my second question would be, as we think about getting ready for the AI opportunity, what is the standard power density to which you build your current data centers? As part of that, as you consider the AI deals that are on the market, what is the density that those workloads are running at? To the earlier point, do they require liquid cooling? Any color there would be great. Thank you so much.

William Huang

What was the first question?

Dan Newman ***GDS Holdings Limited - CFO***

The first was about what was holding back demand in China? What are the cloud customers --

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

Evolution of demand.

William Huang

Okay, I think there are a couple of things.(added by company after the call) I think the cloud players in China I think now they adjusted their strategy. They more pursue quality of the revenue, not just quantity. So this is, I think, in the midterm and long term is very good for data center player because historically the disclosure number including a lot of stuff like CDN, like network or what they call integrate cloud. So the number is big, but also it's some system integration.

But what we know is as those guys start to focus on the growth and real public cloud computing revenue, which we believe this is the right strategy and, given time, they will grow their revenue properly and will drive more high-quality data center demand in the future. That's what we see. This is the revolution from our customers. I think this will get -- in the future will create more healthy data center demand for all the industry. This is number one.

On the other hand, I think the AI has been a hot topic in China already for a while. China already announced eight large language model permission. But in terms of timing, I think, as I mentioned, it's still a little early, because the developing schedule is behind the US, so what we are already seeing is global data center driven by the older US-based large language model, this is not happening in China, but it's coming.

So I think it still needs time, but in China still has another issue, which is the supply issue in terms of the chips. I think this needs maybe 12 months, maybe 18 months to solve all the issues. What I expect is this will happen in a year or a year and a half, maybe in a big wave.

The second question, the power density, of course GDS is always leading the power density product in China. If we look back to 10 years ago, our first data center, we built a triple high density than anyone else in the market. We are very follow up the global trend and the IT trend, so the last couple of years we started to build very high-power density.

Average power density is 8kW per rack for the last couple of years. Now we also increase to 10kW to 15kW per rack. That's an average number, which means we can serve 40kW per rack. It's no issue for us. Again, I would say not only per rack power density we increased, also we increased each new campus power total capacity. This will position us well to respond to all the AI demands in the next few years, so we are ready for that.

Michael Elias ***TD Cowen - Analyst***

Thank you. Very helpful.

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 ***GDA 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 Piacente Financial Communications. See you next time. Bye.

Operator

This concludes this conference call. You may now disconnect your line. Thank you for your participation. Have a good day.