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# EDITED TRANSCRIPT

GDS.O - Q3 2016 GDS Holdings Ltd Earnings Call

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## CORPORATE PARTICIPANTS

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

**William Huang** *GDS Holdings - Founder, Chairman & CEO*

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

## CONFERENCE CALL PARTICIPANTS

**Gokul Hariharan** *JPMorgan - Analyst*

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

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

## PRESENTATION

**Operator**

Hello ladies and gentlemen. Thank you for standing by for GDS Holdings Limited third quarter 2016 earnings conference call. (Operator Instructions). 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.

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

Hello everyone and welcome to the third quarter 2016 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 Chief Executive Officer who will provide an overview of the business. Mr. Dan Newman, GDS Chief Financial Officer, will then review the Company's third quarter 2016 operational and financial 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 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 and filed with the US Securities Exchange Commission. 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 (inaudible) 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 Chief Executive Officer William Huang, who will start his discussion on slide 3. William, please go ahead.

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**William Huang** - *GDS Holdings - Founder, Chairman & CEO*

Thank you Laura. Hi everyone. Thank you for joining our first quarter earning release conference call as a NASDAQ listed public company. Our initial public offering on November 2 was an important milestone for our Company. It enhances our brand and it increases our transparency. This will help us extend our market leadership position.

Turning to the slide 4, we are very pleased to report and record a quarter with robust financial and operating results as you can see on slide 4.

Let's move on to slide 5 that highlights our sales achievement. We have added nearly 70% to our total area committed year over year. This accelerating growth is primarily driven by strong demand from cloud service providers which has taken off as gigantic companies like Alibaba and Tencent have made it their strategic priority.

From what we know about our customers and where they are at, there is a long runway ahead and the incremental demand is huge. We are just in the early stage of cloud development here in China.

In addition, we won two significant new customers which added to our outstanding portfolio of market-leading customers. One is a top-tier Internet giant in China and the other is a top three technology company from the US. We also won substantial new business from our existing customers.

Turning to our data centers on slide 6, our construction plan is moving forward very smoothly, on schedule and within budget. Our current projects will add around 37,000 square meters of capacity which is already nearly 35% pre-commitment. We continue to look for opportunities to increase capacity to meet growing demand.

In closing, I'm thrilled about the tremendous data center opportunities in China and the rapidly escalating demand we are seeing from our Internet e-commerce and cloud customers. As a the first mover and market pioneer in China, we are well positioned to capture the opportunity, grow the business and deliver shareholder value.

With that I will now turn the call over to our CFO, Dan Newman, who will discuss our financial results and additional key operating metrics. Dan, please.

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

Thank you William and hello everyone. Slide 8 summarizes our third quarter results. Service revenue grew by 57% (sic - see slide 8 "58.4%") year over year and 14% sequentially in the third quarter of 2016. Our adjusted EBITDA margin hit 26.2%, a sign of our operating leverage.

On slide 9 you will see the total area committed increased 70% year over year and 31% sequentially to 58,000 square meters. Total area utilized increased 63% year over year and 7% sequentially to 34,000 square meters. As a result of the strong sales growth, contract backlog, the difference between area committed and utilized, nearly doubled. Contract backlog is an important metric as it provides visibility to our future revenue growth.

Out of our 24,000 square meter backlog as of September 30, 2016, around 11,000 square meters relate to area already in service and 13,000 square meters relate to area under construction. Based on minimal contractual commitments, the backlog will be largely delivered within the next four to five quarters. We always plan on the basis of contractual minimums. In practice, we consistently see our customers moving in ahead of schedule. Average selling price or ASP for the backlog as measured per square meter, is in line with what we are achieving for our current revenue-generating space.

At this point I would like to update you on our customer development. We recently became aware that one of our customers intends to terminate its contract with us as a result of a merger between the customer and one of its competitors in China. This customer represented 3.7% of our total area committed and 3.6% of our area utilized as of September 30, 2016, and was based out of our Shanghai Number 1 and 2 data centers. We are working through the details, but we expect the customer to terminate either at the very end of 2016 or early in January 2017. We are entitled to a termination fee equal to around nine months revenue from the contract.

We have strong demand for our Shanghai data centers and as a result we are confident we can re-sell the space terminated by this customer by mid-2017. In sum, the contract's termination is not material to our business and it will not negatively impact our 2016 and 2017 financial performance. We will provide you updates on our re-sell progress at the time we report our fourth quarter 2016 earnings.

Turning to slide 10, the increase in our service revenue over the previous quarter was mainly due to an increase in area utilized as customers moved in, and an increase in revenue generated by our Guangzhou Number 1 and Shenzhen Number 2 data centers which commenced operations during second quarter 2016.

Our monthly service revenue per square meter decreased to $401 for the third quarter 2016 compared with $413 for the second quarter of 2016. This slight change is a function of lower billings for new utilized space during the transitional period of the start of new contracts.

Slide 11; adjusted EBITDA was $11.7 million in the third quarter 2016, and 82.7% increase over the third quarter 2015 and a 65.2% increase over the second quarter of 2016. Adjusted EBITDA margin was 26.2% in the third quarter of 2016, compared with 22.5% in the third quarter of 2015 and 20% in the second quarter of 2016. Excluding IT equipment sales and related costs, adjusted EBITDA margin for the third quarter of 2016 was 27.4%.

Utilization rate of area and service was 70.4% at the end of the third quarter 2016, compared with 56% at the end of the third quarter of 2015 and 66.2% at the end of the second quarter of 2016.

Our capital expenditures on slide 12, increased in the third quarter 2016 to $58 million, mainly due to the accelerated development of our Shanghai Number 3 data center, the cost of completing the newly acquired Guangzhou Number 1 data center and the initiation of our Shenzhen 4 project.

For our data centers under construction as of the end of the third quarter 2016, we need to incur an additional $255 million to complete the construction and full fit-out. We have achieved an overall pre-commitment rate of 34.5% for those centers under construction which reflects the strength of demand. We have significant demand in hand and contracts in process for the available resource that is scheduled to come into service between now and mid-2017.

Now turning to our balance sheet and liquidity on slide 13. As of September 30, 2016 gross debt was $589.6 million of which 83% was long-term. We had cash of $119.8 million. And the net proceeds from the IPO were a further $180 million, net of underwriting discount and IPO-related expenses. Proforma for the net IPO proceeds, our net debt to the last quarter annualized adjusted EBITDA ratio at the end of the third quarter of 2016 was 6.2 times.

We recognize that our leverage level is higher than you would typically see for mature market data center businesses. However, a lot of our debt is project based and tied to the cash flows of those projects. As a result, we can manage higher nominal debt levels. And we are confident of our ability to manage debt at these levels and higher going forward.

Finally we will not be providing forward-looking guidance as part of today's earnings conference call. We intend to provide forward-looking guidance for 2017 at the time we report our fourth quarter 2016 earnings.

This concludes our prepared remarks. We now welcome your questions. Operator, please go ahead.

## QUESTIONS AND ANSWERS

**Operator**

Ladies and gentlemen we will now begin the question and answer session. (Operator Instructions). And the first question comes from the line of Gokul Hariharan from JPMorgan. Please ask your question.

**Gokul Hariharan** - *JPMorgan - Analyst*

Hi. Thanks William and Dan for the presentation and congratulations as the first quarter as a public company. A couple of questions I had were, I think, first of all, in terms of this contract that is being terminated, could you talk a little bit about the standard procedure in terms of if there is another termination or something like that is it going to be the standard procedure in terms of having this kind of six to nine months or six months to 12 months kind of termination procedure, in terms of penalty being paid. That is my first question.

And the second question is in page 12 you have a schedule of data centers coming into service. Could you talk a little bit more detail in terms of the pre-commitment rate, especially for some of the data centers which are at the lower end of the pre-commitment rate? How do you see the demand from the customer even though they have not been -- obviously been pre-committed? Thanks.

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

Hi, Gokul, it's Dan here. Thanks for your questions.

Regarding the first question, if I understood correctly, you're really asking what is our policy in terms of contract terms, how we protect ourselves with termination fees or penalties. So for the larger contracts, the approach is always to have a very substantial buffer. The way it's structured varies from case to case.

As I mentioned, in this case the termination fee that we're entitled to amounts to around nine months' revenue, which we'd have expected to generate from the contracts. That's typical of the way these contracts are structured.

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**Gokul Hariharan** - *JPMorgan - Analyst*

Okay.

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

Okay. Second question regarding the pre-commitment rate. This is for -- we had a number of different data centers coming into service before the end of this year, and then at various times during the first half of next year.

As you know, the sales process can be quite long and we may win the business and get into contracting but it may take months before we reach the point at which we can talk about it and disclose it. I mentioned in my prepared remarks that we are very comfortable about the demand which we have in hand and the contracts which are in process for that resource which is coming on stream between now and the middle of next year.

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**Gokul Hariharan** - *JPMorgan - Analyst*

And for the next year, as on slide 6 I think you provided a kind of end of period area under service kind of disclosure. So is the ramp next year going to be fairly smooth across the various periods in terms of new data centers coming into operation, or is there any kind of queue in terms of when do most of the data centers come into operation next year?

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

Yes. Well, as I mentioned there's 24,000 square meters of backlog and 13,000 out of 24,000 is pre-commitment. So the move-in period will not begin until those data centers come into service. So naturally there's some delay there.

But if you're asking about the kind of quarterly forecasts for the conversion of the backlog, all I can say at this point in time is that most of that backlog will be implemented within four to five quarters and I base that statement on contractual terms. But what's going on here is customers are securing resource and then they want flexibility as to when they avail themselves of that resource. In practice, we consistently see them moving in ahead of the schedule in the contract, but that's not something that we plan on but something that we are prepared for in terms of having a short lead time to delivery.





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**Gokul Hariharan** - *JPMorgan - Analyst*

Okay. Thanks, Dan. Sorry, one -- the part I was asking about is you have area under service and construction which goes from around 63,000 square meters to [86,000] (corrected by company after the call). I think that is virtually the construction plan to the next year. Is that more or less linear through the different quarters of next year or is there any kind of first half or the second half, any kind of seasonality that we need to think about that part?

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

Sorry, Gokul, I lost you. You mean seasonality in terms of new business?

**Gokul Hariharan** - *JPMorgan - Analyst*

No, no, no. In terms of the build-out rate, the expansion, I think you were adding about [22,000] (corrected by company after the call) square meters next year; is there any split? When do these -- are they coming in pretty much linearly through the next year or not?

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

I think on page 6, you'll see that around 14,000 square meters will come into service before the end of this year, and then around [14,000] (corrected by company after the call) in the first half of 2017 and about another [8,000] (corrected by company after the call) in the second half of 2017.

**Operator**

And your next question comes from the line of Colin McCallum from Credit Suisse. Please ask your question.

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

Okay, thanks very much for the opportunity. Just two quick questions from me. Page 12 of the presentation, the data centers under construction, I just want to double-check for the pre-commitment rate that you have there, is that the pre-commitment rate as of the end of the third quarter, or is it as of now, if you see what I mean?

That's the first question, and then the second related question is what would you -- is there any particular reason why it looks like Shenzhen 3 is only 21% pre-committed versus Shanghai 3 68%. Given that it's the fourth quarter and we're obviously are deep into fourth quarter, what would you ascribe the difference to in those commitment rates? Ty.

Dan Newman: Yes, thanks, Colin. This data is at the end of the third quarter, September 30. I appreciate that we're quite a long way past that quarter; we had an IPO in a quiet period. So we've made progress since then but disclosure is at that date.

With regard to Shenzhen 3, if you'll notice, this is a relatively small data center. It's only 2600 square meters, which is about a quarter of the size of our standard Shanghai data centers.

It's located in the central business district of Shenzhen, just across the border from Hong Kong. This is positioned to serve financial institution customers and large enterprises, MNCs. So maybe you can call it, it's retail, and we do not -- we will -- our approach to leasing it reflects that customer focus.

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

That's very clear. Okay, thank you.

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**Operator**

(Operator Instructions) And your next question comes from the line of Jonathan Atkin from RBC Capital Markets. Please ask your question.

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

Yes, thank you. A couple. I wondered, perhaps for William, if you could talk a little bit about the big cloud users in China and just at a very broad level, how much of their future spend do you see occurring in the major metros versus the more rural areas and the cloud parks.

And then secondly, on the -- turning back to the first question that was asked, the customer that's terminating, I wondered how much of the future backlog was represented by that customer, if any. And as you look to resell the space, will there be any technical work required to fit it out in a different manner to make it saleable to a new customer? Thank you.

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**William Huang** - *GDS Holdings - Founder, Chairman & CEO*

Jon, this is William. Based on my observation and my understanding, currently all the core major players, they will spend more cost for the data center in a tier 1 city, which we talked to and present this trend in that during our roadshow period.

I think it's a major -- we're still consistent to this. If you look at some newcomers like a domestic newcomer, or let's say for multinational players, they jump into China, they still -- what we find is they still will choose tier 1 city as their first landing place. I cannot say the exact number, but the trend is there.

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

Thank you.

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

Yes, okay. Jon, it's Dan here.

You asked about the materiality of the customer which is terminating. As I mentioned, they represented 3.7% of our total area committed at the end of the third quarter and that translates into just over 2000 square meters. So in the context of our net add this year of nearly 25,000 square meters in the first nine months, then that gives you a direct comparison.

This customer is located in our Shanghai 1 and 2 data centers. That's the Waigaoqiao campus, which has proved to be highly marketable. The first data center on that site is 95% committed and the second is 96% and the third, which is still under construction, is around 65% pre-committed.

We have more than 60 financial institutions, large enterprises, MNCs and the largest internet companies in China, the largest technology companies in China, all with a substantial presence on that campus. So we believe the demand that will come from that installed customer base is very strong. Part of the space was in Shanghai 1; it's about 13% of that total.

We've already released that back to an existing customer and for the remainder space, this is a very what we call high power customer. The data center resource consisted of very high-powered racks.

So that's what's being installed. That positions us very well because that's a scarce resource and it's the sweet spot in terms of demand in the market now.

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

Great, and then finally, just looking at the development pipeline and data centers under construction, one of the bigger locations is Beijing 2. Can you speak a little bit about to the demand such that you would anticipate coming into that site versus say in Shanghai and elsewhere?

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**William Huang** - *GDS Holdings - Founder, Chairman & CEO*

Yes, John. The Beijing demand is very, very strong. Frankly speaking, we are a little bit surprised at the result as we have mentioned during our period that we want to increase our market share in Beijing. That's our next year's target.

But based on the current -- the Beijing 2 which is under construction, it's already the -- in our internal pipeline almost let's say committed over 50% based on a lot of the larger core service providers. So we are confident it will lead to cover close to 100% after two or three quarters.

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

Thank you.

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**Operator**

(Operator Instructions) As there are no further questions, I would like to now turn the call back over to the Company for closing remarks.

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

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

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**Operator**

Ladies and gentlemen, that does conclude our conference for today. Thank you for participating. You may all disconnect.

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