招銀国际
CMB INTERNATIONAL

Fixed Income
Credit Commentary

9 December 2020

CMBI Credit Commentary

21Vianet – VNET Sanguine outlook from 3Q2020 results

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Bottom line: VNET's strong traction in winning wholesale IDC projects from clients, and its ability to balance utilization rate amid expansion show its competitive edge while it seeks to maintain its market share in 3rd party IDC industry. This is because clients are increasingly motivated to use 3rd party IDC for budget flexibility, and once deployed, clients have inertia to switch.

The favourable strong industry demand also supports equity valuation for the sector, and bolds well for hyperscale IDC provider - VNET's capital market access. We expect VNET to balance its funding mix for its high capex need in 2021-2022, this is because winning wholesale projects provides some pre-commitment and traction for VNET to negotiate project financing.

Following a series of equity-like instruments that are well in-the-money, VNET's USD bond becomes its limited bullet maturities, which support its bond valuation. We also do not expect large disruption to VNET's operation or financing channel, if TUS goes into restructuring - See #6.

(As of 30 Sep 2020: Total adj. Debt of RMB 7.485million, in which USD bond of RMB 2,024 million, Bank loan of RMB 568 million, Convertible bond of RMB 1,400 million, preferred shares of RMB 1,050 million and lease liability of RMB 2,443 million)

1. VNET reported better than expected 3Q2020 results

- The company's 3Q2020 revenue of RMB 1,246 million (+27% yoy) was at the high-end of its prior guidance, while EBITDA of RMB 368 million (+35% yoy) exceeded expectation.

- In 3Q2020, utilization rate improved to 64.2%, from 61.4%/60.4% in 2Q2020 and 1Q2020. Its retail MDRR also rose to RMB 9,074 (+4.2% yoy). Its total number of cabinets increased to 51,476 (+7,417 QoQ and +19,360 YoY). The good operating performance (in terms of recovering utilization and improving retail MDRR), despite large-scale expansion, shows a strong demand for VNET's IDC service and some traction of VNET managing execution risk amid expansion.

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2. **For next 2 years, VNET further raises annual Capex guidance to RMB 5 billion with a target of 25,000 cabinets/180 megawatt addition each year.**

   - The new capex plan is, once again increased from RMB3.2billion – RMB3.4 billion announced Aug 2020. We reckon strong demand for 3rd party IDC prompts VNET to accelerate wholesale expansion now.

   - High switching cost for existing IDC clients also increased VNET's customer stickiness, which, in our view, propels VNET to expedite expansion to secure good locations in T1-2 cities, and lock up pre-commitment from valuable clients.

3. **Aggressive expansion risk is partly mitigated by VNET's revised focus to wholesale project.**

   - Management stated 80% of future cabinet addition will be used for wholesale projects, which in our view, provides higher degree of revenue/cash flow visibility relative to retail projects. This is given higher initial utilization and shorter ramp-up period, at the expense of likely lower margin.

   - VNET shared it has recently won a new cloud customer, in addition to existing pipeline with Alibaba.

   - With that, at 3Q quarterly results call, management stated they expect by the end of first year for its new capacity, utilization rate will reach 40%; and overall utilization rate will be above 60% for next 3 years. Management also expects 2021's EBITDA margin to be similar to 2020's, though acknowledging some downward pressure to margin.

4. **We estimate VNET has sufficient rating headroom for expansion in 2021.**

   - This is given its downgrade trigger is at 2x EBITDA Interest coverage, compared to its current level of 2.8x -3.0x (RTM 3Q2020 basis)

   - *S&P revised its outlook on VNET to stable, from negative in Sep 2020, following its near-term improvement in leverage to below 5x after equity issuance. The stable outlook reflects S&P expects the company to expand ambitiously, leverage will remain elevated and large negative free cash flow will persist.*

- Having said that, we assess VNET will need to continue managing its financing sources, i.e. balance its use of equity/equity like funding to lower fixed charge, given its cash flow generation lags and fall short of its large capex need.

5. Recap of equity-like/equity issuance in 2020

- 2020 Feb: USD 200 million **Convertible Bond** (*in the money*), convertible by Feb 2023 at ADR price $12 per share, 2% annual interest coupon and redeemable by investors at 109 at Year 3.

- 2020 Jun: USD 150 million **preferred share** to Blackstone (*in the money*), convertible at ADR $17 per share, 4.5% dividend distribution prior to conversion to ordinary share.

- 2020 Aug: USD 390.5 million **new share placement** at ADR $20.75

6. TUS Holding impact

- If TUS Holding default and enters restructuring, we assess the most direct impact to VNET would be in a Change of Control causing acceleration of USD notes and CB. The CoC risk, however, similar to its potential delisting risk, can be potentially mitigated by consent solicitation to seek waiver from bondholders.

- There is no cross-default between Tus and VNET. As of 30 Sep 2020, VNET also has limited bank loan of RMB 568 million, relative to its cash on hand > RMB 5 billion. Hence liquidity risk from banks accelerating their bank loan is still manageable, in our view.

- We think operational disruption from a potential TUS restructuring should be manageable as well, given VNET is independently run and separately listed. TUS only appoints 1 out of its 8 total board members, despite its 48.8% voting right.

- Lastly VNET's voting composition offers protection from parental intervention. In Oct 2019, VNET issued 60,000 class C ordinary shares to its founder that gave him veto rights to important matters. These include appointment or removal of directors, entering into any agreement with shareholders holding >10%.

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