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Title: Tucows Inc.'s (TCX) CEO Elliot Noss on Q2 2018 Results - Earnings Call Transcript – August 8, 2018
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Call Start: 17:05
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Executives

Elliot Noss - President and CEO
Dave Singh - CFO

Presentation

Operator

Welcome to the Tucows' Second Quarter 2018 Investor Call. Beginning with this call, Tucows is evolving the format of its investor calls such that management has pre-recorded its prepared remarks on the quarter and outlook for the company, in lieu, of the usual question-and-answer period following management's prepared remarks, shareholders and analysts are invited to submit questions to Tucows management via email at ir@tucows.com, that's ir@tucows.com. Management will then post a recorded audio respond to the most salient questions on Wednesday, August 22nd at 9 o'clock A.M. Eastern Time.

Now onto management's prepared remarks. On Wednesday August 8, Tucows issued a news release reporting its financial results for the second quarter ended June 30, 2018. That news release along with the company's financial statements are available on the company's website at tucows.com under the Investors' heading.

Please note that the matters the company will be discussing include forward-looking statements, and as such, are subject to risks and uncertainties that could cause the actual results to differ materially.

These risk factors are described in detail in the company's documents filed with the SEC, specifically, the most recent reports on the Form 10-K and Form 10-Q. The company urges you to read its security filings for a full description of the risk factors applicable for its business.

I would now like to turn the call over Tucows' President and Chief Executive Officer, Mr. Elliot Noss.

Elliot Noss

Thanks Michael. I'll begin with some comments on the new format and an overview of the financial and operational highlights for the second quarter of 2018. Dave will then provide a detailed review of our financial results. And I'll return with some concluding remarks.

I wanted to start with a couple of comments on the new format. I thought a quote from a McKinsey article on improving quarterly calls sets my thoughts up nicely. McKinsey said, nobody has time to analyze the data before the Q&A session and the remarks are often a more convoluted way to convey data than simple tables.

The issues of time to digest results and ask intelligent questions are particularly important for a company like ours. With a shareholder base of long-term value investors and very little analyst coverage. In addition, we regularly have scheduling issues for the few participants who do ask questions on the call.

As described in our news release and the intro to our remarks, we will be taking questions by email for a week and then taking a week to prepare and provide answers. Questions of general interest will become part of the audio response that will be published on the Investor site. Questions that are more specific will be answered directly. All questions will receive a response. At its core, this is an attempt at improving our shareholder communications. As with everything we do, we are open to feedback.

The second quarter, once again, saw solid performance in each of our businesses. Total revenue was $81.1 million, which was down from $84.2 million in Q2 of last year, but expected due to the bulk transfer of 2.6 million virtually no margin domain names during the first quarter of this year.

More importantly, total gross margin across the business for Q2 increased year-over-year by 7%. Net income for the second quarter was $3.6 million, down from $5.2 million, reflecting a number of small impacts that Dave will speak to in a few minutes. Adjusted EBITDA increased 8% to $11.2 million from $10.4 million.

Turning to each of our businesses. Our Domains business continue to deliver the consistent performance that we've come to expect quarter-after-quarter. And just a reminder that as of last quarter, the Domains metrics we are now reporting are an aggregate of the legacy Tucows Domains business and the Enom Domains business we acquired in January 2017.

In the wholesale channel, total registrations were approximately 4 million, which was up 2% year-over-year outside of the large bulk transfer previously discussed. The wholesale renewal rate for Q2 ticked up another percentage point from Q1 to 79%. The retail Domains channel also again delivered steady performance in Q2, with total registrations of approximately 400,000, more or less in line with that for Q2 of last year.

With the continued growth in registrations at Hover being offset by the anticipated decrease at Enom retail. The renewal rate for the retail channel was also 79% in Q2. Both the wholesale and retail rates continue to track well above the industry average.

On May 25th, we successfully launched significant changes to our Domain privacy practices to comply with the EU General Data Protection Regulation or GDPR. We chose to rebuild our processes pursuing Privacy by Design as our goal.

ICANN is required to preserve as much of the status quo as possible leading to what we believe to be non-GDPR-compliant policies, specifically around the collection, sharing, and display of specified pieces of registrants' data. And as you know ICANN is the regulator in the domain name space.

So, we believe that ICANN did not go far enough to comply with the GDPR and they believe we went too far. ICANN filed an injunction in Germany against our subsidiary EPAG based in Bonn. The German Court ruled in our favor, denying ICANN's injunction. ICANN subsequently asked for a review of that decision and again, it was denied.

The case then moved to a Higher Regional Court in Germany and on Friday of last week, August 3rd, the Regional Court upheld the Lower Court's decision, again denying, ICANN any preliminary relief. We should note that we don't consider this process to be acrimonious as both ICANN and Tucows -- and in fact, the whole industry, would welcome clarity on the GDPR.

Finally on Domains, the Enom integration continues to move forward and with GDPR behind us, we can devote more time and resources here. We're seeing efficiencies already and expect them to continue through 2019. And as the work progresses, we are also finding this creating opportunities for more efficiencies across the whole business.

Now, onto Ting Mobile, despite increasing competition and the need for some freshening up of the offering, Ting Mobile remains a profitable growing business. That growth and cash contribution in the mid-teens year-over-year is currently being achieved by growing gross margins through lowered costs, by efficiencies and spending, and growth in users through adding user bases.

Revenue is up 2.5% versus Q1 and 10% versus a year ago. Margin is up 3.1% versus Q1 and 13% versus a year ago. Churn, based on the new methodology that we outlined last quarter, was 2.74% among the core non-RingPlus base versus 2.8% in Q1 and 2.45% in Q2 2017.

We do see rising mentions of our data pricing in particular from departing customers and we know from our own history that improved customer retention will be the first benefit we see when we address pricing.

As you might have read, we have agreed to purchase customers from another Sprint and T-Mobile MVNO named The People's Operator or TPO, that is closing its U.S. operations. We will be attempting to migrate about 8,000 to 10,000 customers to Ting in the coming weeks.

We do not know how many of them will complete the migration or stick around beyond initial incentives. This continues to be a tactic not a strategy, but it is one that we have now employed four times in the last four years.

Competition is fiercer. MVNO is a tough space if you don't have the core competencies around billing, provisioning, and customer care that we do. Other MVNOs who are ending operations for one reason or another know us and trust us as a home for their customers.

Our carrier partners are thrilled because we keep those customers from scattering to the winds and the carriers trust us to deal with the technical elements of migration well and to benefit from our low churn. All this has become an unexpected, but welcome arrow in the quiver.

In terms of organic customers, our churn continue to outpace our gross ads again in the second quarter. We finished Q2 with just over a 163,000 accounts and 282,000 subscribers, down about 2,000 accounts and 800 subscribers after adjusting for 3,200 subscribers from one large account that we shut-off because they were inactive and were generating no revenue with unnecessary costs.

We expect organic customer growth to benefit significantly over the next iteration of Ting Mobile. Last quarter I talked about the next iteration of Ting Mobile. I would like to provide an update on that.

First, remember that unlike most carriers, when we improve pricing, we always make sure our current base can participate. So, our pricing decisions first impale calculating that clear tradeoff between near-term gross margin dollars and customer growth. We're in the process of validating concepts with customers and prospects and we're doing this through both qualitative and quantitative research.

We're looking for additional whitespace to deliver something that others are not and we believe, these opportunities exist. The key will be finding the right balance between simplicity and control.

Our early customer engagement has confirmed that our customers who presumably many like them, love the opportunity to save money by being thoughtful about their usage. We suspect that most prospects do not want to work so hard. We think there may still be tremendous opportunity to satisfy both.

We also think there is ample opportunity to expose and address the confusion and game-playing in the industry such as leading with prices that are not readily available, boasting unlimited, but in fact, has significant limits, or charging unexpected fees on particular types of common mobile usage.

We know that there is still lots of room to reduce confusion. We did that in a way that led the industry and then watched the industry copy us for the last few years. We hope to do the same for the next few.

As for timing, between analysis, engineering, and designing new web pages, control panels, and support content, we think it is best to expect the next iteration of Ting Mobile in early 2019. But I will give another update, of course, on the Q3 call in mid-November.

Finally, we're expanding our presence of retail with Ting SIM cards now hanging in over 300 Best Buy locations and 1,800 Target locations around the country. These offer low-cost exposure and credibility and are potentially great environments for prospects to learn about Ting.

For the first time, we're seeing retail contribute at levels that make it part of the mix. But that is still less than 10% and has lots of upside. So, a lot of moving pieces on Ting Mobile, however, we have some unique core assets that put us in an enviable position to succeed; a loyal customer base, a salient brand, technical prowess, outstanding customer support, and profit margin to spare. With all these assets and a market share of less than one-tenth of 1%, I believe as much as I ever have that Ting Mobile is a growing, vibrant business with lots of upside.

Ting Internet continues its steady progress from network builds and expansions across the footprint, to serviceable addresses, to subscriber activations, to dependable recurring monthly revenue.

At the end of Q1, we had passed 17,500 serviceable addresses and had about 5,000 active customers. In Q2, we added about 3,000 addresses and 300 customers to get totals of roughly 20,500 serviceable addresses and 5,300 active customers. But note, that much of the effort in the first two months of the quarter was spent on construction at the beginning of the funnel.

In fact, an outsized portion of those new serviceable addresses were added just in June, with a couple of new neighborhoods in Charlottesville, a small new wave as part of the municipal build in Westminster, consistent expansion in Holly Springs, and the first addresses to go live in Sandpoint, Idaho. So, we have likewise been enjoying a little surge of installs in the early part of Q3 seeing over 300 new customers in July alone.

Last quarter, I reiterated a goal of 40,000 serviceable addresses by the end of the year. I also warned that this is a construction project with a steady stream of learning opportunities. I now expect that we will finish 2018 in the 30,000 to 35,000 serviceable address range rather than 40,000.

There were two major reasons. First, the effort to properly expand network capacity in Charlottesville has taken longer than originally hoped. That work will not start taking effect until early 2019.

Second, the build in Centennial, Colorado was initially delayed due to longer than expected negotiations with the city and then longer than expected ramp times with local contractors.

Like many industries, we are seeing localized labor shortages. We've hit our stride in Centennial now and will be lighting up our first customers in Q3. But we will not catch up to where we had originally planned.

We are finding as many homeowners have before us that once you have a delay in a construction project, there is generally no making it up. Overall, I continue to be pleased with demand and how serviceable addresses have translated directly into recurring revenue. And I'm pleased with how the teams are managing build costs on one end and driving preorders and activations on the other. As we revisit network capacity and existing neighborhoods in Charlottesville, we've enjoyed outstanding adoption in a couple of new neighborhoods.

Holly Springs continues to be the model of a well-chosen, well-planned, well-executed Ting town and we remain confident that we will blanket our targeted areas there by the end of the year. As Westminster slowly builds out its municipal network, we feel good about our take rates and are pleased to see this city stepping up its construction efforts.

We lit up the first customers in Sandpoint in early June and are scooping up preorders now. We expect to start lighting up Centennial next month and we have already begun construction in Fuquay-Varina, Holly Springs' next door neighbor to the south.

Finally, I'm feeling confident that we're in the homestretch of our Ting TV launch, an effort that has touched so many parts of the organization from hardware to software to contracts and legal and has included some learning opportunities of its own.

We have completed the physical construction of the TV head add [ph] in Holly Springs. That is the equipment that receives and distributes broadcast signals. All the major content carriage approvals have been secured and we're currently receiving live and test signals from most of the major content owners.

Customer set-top boxes have been received at our distribution warehouse and are being prepared for deployment to our first towns. I remind you that the value of a TV product to our business is not the extra bit of ARPU it will contribute, but rather the improved conversion it will drive among those prospects that would love to have Ting crazy-fast fiber internet, but do not want to leave their traditional cable television package behind.

Research suggests that still over 80% of the country pays for a TV package. It is cost-prohibitive to get internet from one provider and TV from another. So, our customer acquisitions have been mostly limited to that smaller universe of cord-cutters and those willing to take it on for their first. We expect to have Ting TV in market by the end of the year and look forward to that boost to Ting Internet adoption through 2019.

Finally, we continue to remain positive about the core metrics, 20% adoption after one year, 50% adoption after five. $2,500 to $3,000 per home at that 50% adoption, with a return of a $1,000 in recurring margin a year.

I'd now like to turn the call over to Dave to review our financial results for the quarter in greater detail. Dave?

Dave Singh

Thanks Elliot. Total revenue for the second quarter of 2018 was $81.1 million, down from $84.2 million for the same period last year, primarily due as Elliot explained earlier, to the bulk transfer out near that $2.7 million Domains in Q1 of this year, which accounted for approximately $8 million a very low margin revenue in Q2 of last year. When comparing revenue on a sequential basis, I will remind you that the transfer out also resulted in $14.6 million of accelerated revenue in Q1 of this year.

Cost of revenues for network costs decreased 9% to $54.5 million from $59.5 million for the second quarter of last year with the decrease due to the lower revenue in Q2 of this year.

Gross profit before network cost for Q2 increased 7% to $26.6 million from $24.8 million. As a percentage of revenue, gross margin before network costs expiry to 34% from 30% for Q2 last year. This year-over-year increase was primarily the result of growth in Ting Mobile and the negative impact in Q2 last year from the acquisition of the Enom business, the accounting of which required amortizing into revenue, deferred revenue that was a quarter of fair value of the acquisition.

I'll now review gross margin for each of the Domain Services and Network Access businesses. Domain Services' gross margin for the second quarter increased 5% to $15.5 million from $14.8 million for the same period a year ago.

As a percentage of revenue, gross margin for Domain Services for Q2 increased to 27% from 24%, which reflects the impact of the Enom acquisition-related deferred revenue fair value adjustment in 2017 I discussed a moment ago.

Looking at the individual components of Domain Services, gross margin for the wholesale channel decreased 4% to $10.5 million from $10.9 million for Q2 of last year, with a decline primarily associated with the outsized expiry revenues in Q2 2017.

As a percentage of revenue, gross margin for wholesale increased to 22% from 20%, partly due to the positive impact of the transfer out from $2.7 million very low margin Domain names.

Gross margin for retail Domain Services increased 29% to $4 million from $3.1 million for Q2 last year. As a percentage of revenue, gross margin for retail services increased to 48% from 41%. The increase is on both an absolute and percentage basis reflect the impact in Q2 of last year of the amortization of the fair value adjustment.

Gross margin for portfolio services increased 24% to just under $1 million from $0.8 million for Q2 last year. As a percentage of revenue, gross margin increased to 83% from 81% in Q2 2017.

Moving now to Network Access, gross margin for the second quarter of this year increased 13% to $11 million from $10 million for the same period last year, due in primarily by the increased data usage and reduced carrier costs that Elliot referenced earlier. As a percentage of revenue, gross margin for Network Access declined marginally to 45% from 46% for Q2 of 2017.

Turning now to costs. Network expenses for the second quarter of 2018 increased 29% to $4.4 million from $3.4 million for the same period last year. The increase is primarily due to increased amortization associated with the investment in the Ting fiber network.

Total operating expenses for the second quarter of 2018 increased 15% to $16.4 million and $14.3 million for Q2 last year. The increase was due primarily to the following; workforce and third-party workforce-related expenses excluding stock-based compensation increased by $1.2 million, primarily the result of the continued growth in our overall Ting subscriber base and footprint and to a lesser extent, unfavorable foreign exchange impacts from a stronger Canadian dollar in the second quarter of 2018 as compared to the second quarter of 2017.

Workforce restructuring costs increased $400,000, while stock-based compensation was up $300,000, primarily from the grants in the third quarter of 2017 and the second quarter of 2018.

From a foreign exchange perspective, we experienced a $0.1 million unrealized loss in Q2 2018 as compared to a neutral impact in the same quarter of last year, which represents a year-over-year increase of $0.1 million in expenses.

Depreciation and amortization was up $200,000, primarily due to the acquired Roam Mobility intangibles related to customer relationships. These increases were offset by marketing expenses being down $300,000 due to timing and spending for Ting Mobile and Ting fiber.

As a percentage of revenue, total operating expenses increased to 20% from 17% for Q2 a year ago. Net income for the second quarter of 2018 decreased to $3.6 million or $0.34 per share from $5.2 million or $0.50 per share for Q2 last year. Adjusted EBITDA for the second quarter increased 8% to $11.2 million from $10.4 million for the same period last year.

Turning to our balance sheet and cash flows, cash and cash equivalents at the end of the second quarter of this year was $11.2 million compared to the $16.6 million at the end of the first quarter of this year and $15.1 million at the end of the second quarter of last year.

The decrease in cash in Q1 was a result of the use of $3.8 million for the net repayments of our loan and the investment of an additional $7.3 million and continued investment in property and equipment. These were substantially offset by the generation of $5.8 million in cash flow from operations.

Deferred revenue at the end of the second quarter of 2018 was $152 million, up from $151 million at the end of the first quarter of this year and down from $161 million at the end of the Q4. The decrease from the fourth quarter is due to the name chief [ph] revenue acceleration previously mentioned.

That concludes my remarks. I'll now turn it back to Elliot. Elliot?

Elliot Noss

Thanks Dave. I would like to start my closing remarks by reiterating our $54 million cash EBITDA guidance. When investors share why they like to Tucows, they most often talk about capital allocation and return on investment. Too often, when we are analyzing return on investment, we look at return not the investment.

Particularly in capital light technology businesses, the ROI is often more a function of a low denominator than a high numerator. This is what makes the Ting Internet business so powerful. It allows for deploying large amounts of capital, while still providing a great return, as long as it has done well, of course.

And this capital is growth CapEx, not maintenance CapEx. This is an important distinction. Markets are funny. They would generally prefer if we took that same money and used it to make small acquisitions each quarter. Investing in fiber is the same in terms of growth, but far superior in terms of strategic risk and integration risk.

And for additional benefit, the growth CapEx spend is tax preferred, creating more free cash. Luckily for us our investors appreciate this distinction. That is why there is something in this quarter's numbers that may not jump out at first review, but that I am quite excited about it. And that is the CapEx spend of $6.7 million. This is our highest spend ever. It is up 48% on Q1, which by the way, was our highest spend ever before this quarter and nearly triple Q2 of last year. This number is a function of being able to create opportunities through establishing markets to spend in and to creating capacity by building the organizational muscles that are able to effectively take advantage of those opportunities.

Of course this all must be done while paying careful attention to the numerator in return on investment as well. In this case, focusing on build cost and take rates takes care of that.

The CapEx spend will ebb and flow over time. Every quarter will have its own story, but this quarter, the story is one of hitting a certain stride and cadence, of having the opportunities to spend, and the skills to spend well. And these are the competencies that will serve us for the coming years as we continue to ramp the fiber business and the whole company.

And again, please submit your questions in writing and we look forward to answering them shortly. Thank you.