**Q4 2018 Conference Call Transcript: Tucows, Inc.**

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Tucows Inc. (TCX)
Q4 2018 Earnings Conference Call
February 13, 2019, 05:05 PM ET

**Company Participants**

Elliot Noss - President and CEO
Davinder Singh - CFO, EVP, Principal Accounting Officer & Secretary

**Transcript**

Welcome to Tucows Fourth Quarter 2018 Investor Call. Management has pre-recorded its prepared remarks regarding the quarter and outlook for the company. In lieu of a live question-and-answer period following the prepared remarks, shareholders and analysts are invited to submit their questions to Tucows' management via email at ir@tucows.com.

Management will then post a recorded audio response to questions, as well as a transcription to the Tucows website on Tuesday, February 26, at approximately 4 PM Eastern Time.

Now on to management's prepared remarks. On Wednesday, February 13, Tucows issued a news release reporting its financial results for the fourth quarter and full year ended December 31, 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 to Tucows' President and Chief Executive Officer, Mr. Elliot Noss.

**Elliot Noss**

Thanks, Michael. I will begin our remarks with a review of the quarter. Dave Singh, our Chief Financial Officer, will then review the fourth quarter financial results in detail, and I'll return for some concluding comments.

We are now into our third quarter with the new pre-recorded conference call format. If you have questions coming out of the call, please e-mail them to ir@tucows.com. We will be addressing your questions either directly or in a recorded call that will be posted February 26 at 4 PM. We would also like to direct you to a new document we've made available to investors, the Tucows quarterly KPI Summary, which provides key metrics for all of our businesses by quarter for 2017 and 2018. It's available on the Investors section of the Tucows website.

Now onto the quarter, the fourth quarter, once again, saw solid consistent performance across the business. Total revenue was $86.6 million [later corrected to $85.6 million by the company to align with published results] compared with $90.6 million for Q4 last year. Excluding one-time events, revenue grew 2% compared to Q4 2017. Gross margin dollars increased 8%.

Net income was $4.4 million, which was down 60% from Q4 2017. However, I will note that Q4 2017 did benefit by almost $6 million due to the implementation of the Tax Cuts and Jobs Act of 2017. Adjusted EBITDA for Q4 2018 increased 9% to $16.6 million. The quarter capped off another record year in terms of revenue, gross margin, adjusted EBITDA and cash flow from operations, with the exception being net income with again 2017 net income being outsized as a result of the positive impact of the Tax Cuts and Jobs Act.

2018 revenues increased 5% from the prior year to $346 million. Gross margin increased 16%. Net income was down 24%, while adjusted EBITDA increased 21% to $50.1 million. Finally, cash EBITDA was $53.7 million, in line with guidance for the year.

I'll now review the performance of the individual businesses. Our Domains business saw another quarter of consistent performance. As we began to see in Q3, the wholesale channel again benefited from the price adjustments on Domain services implemented in the first half of the year. While registrations during the quarter, adjusted for the bulk transfer of names, were down 4% year-over-year at approximately $3.5 million, gross margin dollars for Domain Services were up 19% as we continue to see the impact of the pricing standardization earlier this year.

The Wholesale renewal rate continued its trend of consistent performance with Q4 coming in at 77%, above industry average. Gross margin dollars from value-added services for Q4 were down 8%, primarily under performance from the expiry stream, which, with the growth in Domain Services, netted out to an increase in overall Wholesale channel gross margin dollars of 9%.

The Retail Domains channel also saw consistent performance with total registrations in Q4 of approximately 360,000 compared with 380,000 in the same period the prior year, as continued growth in our legacy Hover registrations was more than offset by the continued expected decline in the acquired eNom Retail registrations. The renewal rate for the Retail channel was a solid 77% in Q4, also above the industry average.

In our Portfolio business, we completed another bulk sale of Domains during Q4, which generated about $3.2 million. As I mentioned on the Q4 call last year the last time we completed one of these sizable bulk sales, these are not infrequent enough to be characterized as one-time transactions but are neither is dependable nor predictable as the millions of small customer transactions that drive our other businesses.

Now on to Ting Mobile, service revenue and gross margin in Q4 were flat versus both Q3 and Q4 '17. Revenue for the full year 2018 was up 7% versus 2017 and margin was up 12%. The annual revenue growth reflects account growth in 2017, resulting in a larger base in 2018, more subscribers per account and rising data usage across accounts. The even stronger margin growth also reflects decreased carrier costs.

We finished Q4 with just over 162,000 accounts and about 296,000 subscribers, flat on accounts from the previous quarter and up about 1,000 subscribers. We lost about 3,000 accounts in total for the year in 2018 and gained about 14,000 subscribers. That subscriber growth for the year was driven by large IoT accounts.

Again these accounts are for low margin per subscriber but are still quite profitable and play to our strengths in easy online tools and customer management. We know they are vulnerable to the potential failure of these businesses.

Our gross customer adds outside of MVNO customer migration continued slightly below historical performance. Churn was also high relative to the annual average as it always is in Q4. Specifically, we saw 3.11% churn in Q4 versus 3.07% in Q3, 2.77% in Q2 and 2.86% in Q1. Churn was a similar 3.1% in Q4 a year ago. Overall, churn for the year was 2.95% versus 3.42% in 2017, although again that 2017 number was inflated by MVNO customer migration.

I said last quarter that much of our work on Ting Mobile relies on clarifying our carrier relationships beyond 2019. Of course, those now hinge on the outcome of the pending T-Mobile-Sprint merger. That process has been delayed even further by the government shutdown and could be delayed again. We all look forward to a resolution here.

Meanwhile, I'm excited about the work that we're doing to better define and target our unique segment of prospects. I am pleased with how we've continued to deliver financial growth even as customer growth has gotten tougher. I am confident in the potential that Ting Mobile has to continue to deliver growth in the future.

Finally, in Ting Internet, at the end of Q3, we had roughly 22,500 serviceable addresses in five markets and roughly 6,200 active customers. In Q4, we added over 5,500 addresses ready for service and 800 customers to get to totals of just over 28,000 serviceable addresses and 7,000 active customers. I said last quarter that we expected to be at 30,000 serviceable addresses by the end of the year.

In fact, we did build the network past about 31,000 addresses, but had not yet made about 3,000 of them serviceable by the network. Thus, only 28,000 addresses could order Ting and get service immediately. We will continue to report addresses as they are live, but we note this variation.

Last week, we announced Wake Forest, North Carolina, as our seventh Ting Town and third in the Research Triangle or Greater Raleigh, North Carolina area. Like nearby Holly Springs and Fuquay Varina, Wake Forest brings an enthusiastic municipal partner, attractive density and a growing community of families, businesses, schools and entrepreneurs. We will also benefit from a lot of operational efficiency there, with construction and install teams on the ground nearby.

Additionally, Ting has strong brand awareness in the region. Wake Forest will add about 10,000 serviceable addresses at scale and we expect to start lighting folks up by Q4 of this year. We would be pleased to have more regions like the one we have now in North Carolina. There are great neighborhoods just outside the city limits of Charlottesville that could bring efficient serviceable addresses. There are some opportunities in Colorado, convenient to our current town of Centennial. We still have our eyes all over the country, but it is very appealing to take successful operations and stretch them a bit further as we have done here.

Also last quarter, I described a deal we signed with a private partner for yet another Ting Town. They will build and own the network and we will provide service. That partner is still not quite ready to announce the town and the deal publicly. We will share more as soon as we are able.

Our Ting TV rollout is coming along well. We have a long list of prospects who have indicated interest on our website. Those prospects are almost entirely non-Ting Internet customers, which validates our hypothesis that many people have been waiting on the sidelines for us to offer traditional television.

We are excited about a few opportunities we've discovered on Ting TV to zig where the rest of the industry just keep zagging. All our channels will be HD automatically, because there is no reason anyone would want anything else. We will allow customers to forego renting or buying a cable box from us and instead have the opportunity to host the Ting TV app on an Apple TV or Amazon Fire. A lot of the TV experience is dictated by the major content providers. So we cannot shatter conventions quite as much as we would like. But we are trying and, so far, people seem very excited about getting cable TV without the cable company.

Finally, I want to share that the fiber space is attracting increasingly more attention, more players and more money. We see it in attendance at fiber conferences, RFPs issued and competitive RFPs submitted. We see in some of the investment opportunities that are presented to us. We look at this as a real positive.

We are not possessed of some sort of revealed truth when it comes to fiber. This is a quarter trillion dollar buildout that will take place over 10 years to 20 years. Watching more smart money and more entrepreneurs seeing through the fog that traditional telecom emits is reassuring. There is so much opportunity and still a surprisingly few number of companies pursuing it.

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

**Davinder Singh**

Thanks, Elliot. Total revenue for the fourth quarter of 2018 was $85.6 million, which was down from $90.6 million for Q4 of last year with the decline primarily due to the bulk transfer out of approximately 2.8 million domain names throughout 2018, the bulk of which occurred in Q1 of this year.

These names accounted for approximately $7 million of revenue in Q4 of last year that generated essentially no gross margin. Excluding these names, revenue for the fourth quarter increased year-over-year by 2%. Cost of revenues before network costs decreased 13% to $53.5 million from $61.1 million for the fourth quarter of last year with the decrease due to the decline in revenue in Q4 of this year. I will note that as a percentage of revenue, cost of revenues before network costs decreased nearly 500 basis points to 62% from 67%.

Gross profit before network costs for Q4 increased 8% to $32.1 million from $29.5 million. As a percentage of revenue, gross margin before network costs expanded to 37% from 33% for Q4 2017 and notably 34% for Q3 of 2018. The year-over-year increase was primarily the result of growth in both Network Access and Domains gross margin, including the negative impact in Q4 last year from the acquisition of the eNom business, the accounting of which required amortizing into revenue, deferred revenue that was recorded at fair value at the acquisition.

I'll now review gross margin for each of the Domain Services and Network Access areas. For Domain Services, gross margin for the fourth quarter increased 10% to $19.6 million from $17.8 million for Q4 of the prior year. As a percentage of revenue, gross margin for Domain Services for Q4 of this year increased to 22% from 20%. The increase on both an absolute dollar and percentage of revenue basis was primarily the result of the impact of the eNom acquisition related deferred revenue fair value adjustment in 2017, I just mentioned.

The improvement as a percentage of revenue also benefited from the transfer out of the approximately 2.8 million very low margin names this year. As well a larger bulk portfolio name sale in Q4 2018 helped to improve overall portfolio contribution by $0.5 million.

Looking at the individual components of Domain Services, gross margin for the Wholesale channel increased 9% to $11.2 million from $10.2 million for Q4 2017. As a percentage of revenue, gross margin for Wholesale increased to 24% from 20% mainly due to the positive impact of the transfer out of the approximately 2.8 million very low margin names.

Gross margin for Retail Domain Services increased 8% to $4.5 million from $4.1 million in Q4 2017 and as a percentage of revenue expanded to 50% from 48%. Gross margin for Portfolio Services increased 16% to $3.9 million from $3.4 million in Q4 2017. As just referenced, both periods included the contribution of large bulk domain sales with that of Q4 2018 being somewhat larger than that of Q4 2017. As a percentage of revenue, gross margin was 90% compared with 87%.

Moving now to Network Access, gross margin for the fourth quarter of this year increased 6% to $12.5 million from $11.7 million for the same period the prior year, driven primarily by the improved contribution from the Ting Internet business. As a percentage of revenue, gross margin for Network Access improved to 50% from 46% in Q4 2017.

Turning now to costs, network expenses for the fourth quarter of 2018 increased 15% to $4.4 million from $3.8 million for the same period of 2017. The increase is primarily due to the increased amortization associated with the investment of Ting Fiber network. Total operating expenses for the fourth quarter of 2018 increased 18% to $17.5 million from $14.8 million for Q4 the prior year. The increase is due primarily to the following.

Workforce and third-party workforce related expenses increased by $1.1 million, primarily the result of the growth this year in the number of Ting Mobile and Internet subscribers and the Ting Internet footprint.

A $0.5 million increase in marketing expenditures related to Ting Mobile and Internet, partially due to the reduction in expenditure in the fourth quarter of 2017.

From a foreign currency perspective, we had a $200,000 unrealized loss in Q4 2018 related to mark-to-market remeasurements for our currency forward contracts that do not qualify for hedge accounting compared to our $54,000 unrealized loss in the same quarter last year.

In addition, we experienced a foreign exchange loss on the revaluation of foreign denominated monetary assets and liabilities, which had the impact of increasing our expenses $800,000 on a year-over-year basis. And we had $200,000 increase in other costs, including credit card fees as well as investments in tools and technology to support our growing employee base.

As a percentage of revenue, total operating expenses increased to 19% from 16% in Q4, 2017. Net income for the fourth quarter of 2018 was $4.4 million or $0.42 per share compared with a $11.2 million or $1.06 per share for Q4 2017. As Elliot mentioned at the outset, net income and earnings per share for the fourth quarter, 2017 benefited from the positive implementation impact from Tax Cuts and Jobs Act of 2017, which contributed $5.8 million or $0.55 per share.

Adjusted EBITDA increased 9% to $16.6 million from $15.3 million for Q4 2017. Turning to our balance sheet and cash flows, cash and cash equivalents at the end of the fourth quarter of 2018 was $12.6 million compared with $10.8 million at the end of the third quarter of 2018 and $18 million at the end of the fourth quarter of 2017.

The increase in cash from the end of the third quarter of this year was primarily the result of the generation of $10.7 million in cash flow from operations, offset by our investment income of an additional $8.5 million and property and equipment, primarily for the Ting Internet buildout as well as $0.5 million for acquired intangible assets.

Deferred revenue at the end of the fourth quarter of 2018 was $144 million, down from $148 million at the end of the third quarter of 2018 and down from $161 million at the end of Q4,

2017. The significant decrease on a year-over-year basis is due to the domain name revenue accelerations noted earlier.

That concludes my remarks and then I'll turn the call back to Elliot.

**Elliot Noss**

Thanks, Dave. For 2019, we are providing guidance of $62 million in cash EBITDA and CapEx in the $52 million range. This number compares to roughly $54 million in cash EBITDA for 2018, or roughly 15% EBITDA growth. The CapEx number breaks out into three components, roughly $35 million in fiber CapEx, roughly $13 million in datacenter CapEx and roughly $4 million in regular CapEx.

The fiber CapEx will be increasing from $25 million to $35 million. The $10 million increase should be the number that those modeling at home pay the most attention too. If I were modeling this business from the outside, increase in CapEx on an absolute dollar basis, not a percentage increase would be the way that I would model. In a way, that is what I do.

The number is absolute because these are construction projects with very real human inputs and are simply not a variable that scales in the way that we are used to Internet businesses scaling.

Now more detail on the data center CapEx. In every Ting Internet city, we require a secure space to house our network electronics and as a termination point for our local fiber network. We plan to either own these facilities or lease them directly from a municipal partner as there is too much long-term risk in renting typical commercial space. We also need this type of facility in the rest of our businesses. We need this type of facility for our TV head-ends.

We have significant datacenter financial commitments coming due in 2019 from the eNom deal. Once you build a small footprint, the incremental space is relatively inexpensive. Accordingly, we have made the strategic decision to aggregate our datacenter requirements in facilities that we will mostly own. We believe this provides significant long-term cost savings. As with all our capital investments, we use an IRR threshold of at least 20% in our assessment. Cash on cash returns on this investment are very attractive.

We will be incurring operating expenses for our datacenter strategy in 2019 as well. It is another of the many small places that we trade short-term profitability for longer-term greater returns. Of course, this is compounding. We're already implementing this strategy.

Last year, we purchased a piece of land in Centennial, Colorado, and have started work on that datacenter. It will serve as the fiber root for our Colorado operations as our main West Coast datacenter and as our West Coast head-end for the Ting TV offering.

Today, we again announced an open market buyback program that will commence immediately. The program will allow us to repurchase up to $40 million worth of our shares over the course of the next 12 months. This year, more than any year since 2007, I find myself concerned about a possible recession. That potential will inform our thinking in terms of the program.

We talked last year, about this time, about the breadth of the generational work we were engaged in. That work continues. It would be nice if generational work fit neatly into fiscal periods, but of course it does not. 2018 was definitely a bridge year with a lot of work that will only show itself over time. In 2019, the mix of work moves to include much more that is moving the business forward. Paying down technology debt is virtually unavoidable when you've been around as long as we have. The first benefit is being able to take less time dealing with “break-fix” and more time on productive work that translates to growth.

All of this is to say that 2019 is not as much of a heads down year as 2018, but it is also not yet living in the next chapter of the Tucows story. That is all a bit long-winded for 15% cash EBITDA growth, but I like people to know where we are in the story.

We have been able to grow the Domains business in the mid-single digits even while dealing with GDPR, the Platform work and adding a significant volume of flat to declining business. We've been able to grow the Mobile business cash EBITDA over 10%, while dealing with increased competition, carrier uncertainty and the need to improve customer growth.

We've been able to do these things, while investing significantly in the Ting Internet business, which should provide a platform for profitable investment and really profitable growth for years to come.

In our view, building the first telecom business for the Internet age will take years before its steady-state, but what a fantastic business it is as huge latent demand supports real growth through this long process of learning.

In closing, 2018 was a year in which building for the future was relatively painless and, while 2019 will still contain a significant amount of long-term investment, we will also start to enjoy greater returns.

And with that, I look forward to your written questions and exploring areas that interest you in more detail. And again, questions to ir@tucows.com. Thank you.