tucows

Q2 2019 Management Remarks Transcript

Introduction [Monica Webb]

Welcome to Tucows' second quarter 2019 management commentary. We have pre-recorded prepared remarks regarding the quarter and outlook for the Company. A transcript of these remarks is also available on the Company's website. In lieu of a live question and answer period following the prepared remarks, shareholders, analysts and prospective investors are invited to submit their questions to Tucows' management via email at ir@tucows.com. Management will address your questions directly, or in a recorded audio response and transcript that will be posted to the Tucows website on Tuesday, August 20th at approximately 4 p.m. eastern time.

We would also like to remind you of the Tucows Quarterly KPI Summary that we began publishing on our website in Q4 2018, and which provides key metrics for all of our businesses by quarter since Q1 2018. The updated version is available now in the Investors section of the website, along with the updated Ting Build Scorecard.

Now, on to management's prepared remarks.

On Wednesday, August 7th, Tucows issued a news release reporting its financial results for the second quarter ended June 30, 2019. That news release, and the Company's financial statements, are available on the company's website at tucows.com, under the Investors page.

Please note that the following discussion may include forward-looking statements, which, as such, are subject to risks and uncertainties that could cause 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 Forms 10-K and 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.

Management Remarks [Elliot Noss, CEO]

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

Now on to the quarter.

The second quarter was highlighted by a return to year-over-year growth in both revenue and gross margin. Total revenue increased 4% to $84.1 million, from $81.1 million for Q2 last year, while gross margin dollars increased 14% when correcting for the purchase price accounting treatment for the Ascio transaction, which is a completely non-cash effect. The number would be 11% uncorrected.

Net income was $2.6 million, compared with $3.6 million in Q2 last year, and adjusted EBITDA increased to $11.5 million, from $11.2 million in Q2 last year.

I'll now review the performance of the individual businesses.

Our **Domains** business delivered another quarter of consistent performance, clearly demonstrating the positive impact of our focus on managing this business for gross margin contribution.

Beginning with the Wholesale channel, gross margin was up 20% year-over-year. Within these results, Domain Services' gross margin was up 30%, while Value-Added Services' gross margin increased 5%.

For Domain Services, approximately 40% of the increase was generated by our legacy business, primarily due to the pricing alignment implemented last year. The other 60% was generated by the recently-acquired Ascio resellers. And again, the Ascio contribution was dampened by the accounting treatment I mentioned earlier.

Total Wholesale registrations for Q2 increased 1% year-over-year to 4 million, with this year's total benefitting from the Ascio acquisition. Excluding transactions resulting from the Ascio acquisition, and adjusted for the second portion of the bulk transfer of names last year, total registrations were down 3.5% year-over-year. The strong growth in gross margin dollars on lower transactions reflects our ongoing focus on higher-quality wholesale customers and overall profitability of the business. Consistent with that focus, the renewal rate for the wholesale channel was again a very healthy 76%.

The 5% increase in gross margin dollars for Value-Added Services, which was also up 19% sequentially, was the result of changes we implemented early in the second quarter related to our expiry stream process.

We also continue to see the results of our ongoing platform work, with savings in data center and facilities that will decrease opex by an additional $1 million annually, starting this quarter. And more importantly, the platform work is providing visibility to opportunities for new Value-Added Services for the first time in a long time.

In the Retail Domains channel, total registrations for the second quarter were approximately 370,000, compared with 410,000 in the same period the prior year, with the decline coming primarily from the Enom brands. Gross margin dollars, however, were up year-over-year by 9%, driven in part by the tail end of the impact in Q2 of 2018 of the fair value accounting adjustment on the acquired deferred revenue from Enom retail customers.

The renewal rate for the retail channel was a strong 80%. Renewal rates for both the wholesale and retail channels were once again solidly above the industry average.

In summary, the Domains business is running well and performing to our expectations, including the integration of Ascio, where everything we have seen so far has confirmed our beliefs in both the strength of the team there, and the quality of their customer base.

Now onto **Ting Mobile.**

We finished Q2 with about 157,000 accounts and 280,000 subscribers, a loss of about 3,000 accounts and 4,000 subscribers.

Churn for Q2 was again solid at 2.79%, essentially flat versus 2.77% Q2 a year ago, and 2.83% last quarter. In such a competitive environment, we continue to view these stable churn numbers, and the lifetime customer value they produce, as an indication that our customers love the value and experience they have found at Ting.

Service revenue for Q2 was down 2.6% versus Q2 a year ago and up 3% compared to last quarter. Gross margin on service revenue was down 8.1% versus a year ago, and up 1.3% sequentially. That drop in margin relative to revenue reflects both the carrier penalties that we discussed in prior calls, and significant increases in data usage per account, with lower rates per unit at the high end.

We filed a Form 8-K in May disclosing that we had reached an agreement with STS Media Inc., an MVNO doing business as FreedomPop and Unreal Mobile, to acquire approximately 150,000 subscribers that were on the Sprint network. The price of the transaction was about $3.6 million. I will reiterate that two-thirds, or 100,000 of those subscribers, were spending nothing -- taking advantage of some free service on FreedomPop. Another 25,000, were spending just a bit more than nothing for small top ups. The final 25,000 offered revenue and usage levels closer to, but still below, average Ting customers. We have no interest in a freemium model. But we are confident that both the free and paying customers, at low usage levels, would spend as little as they can spend anywhere on Ting's pay-per-use rates. While many observers feel we are expensive, the unmatched flexibility we offer really does lower people's bills more than they realize.

We have had these customers on the platform for a few weeks. We now have over 12,000 subscribers activated on paid plans, and they continue to come in every day in a still-consistent flow. With incentives to be achieved on our Sprint agreement, efficiencies to be gained on our business, and our track record for retaining these types of customers, we are pleased with this transaction so far.

We will be able to report a lot more on the FreedomPop customer base after Q3, including the final amount of successful activations. Although, even then, I expect them to still be shaking out at churn rates higher than average Ting customers for several months.

I will remind you that we have upfront costs on this acquisition effort between engineering, support, and some customer incentives. Thus, in 2019, we do not expect FreedomPop to have any material impact on cash EBITDA.

As we talk about an acquisition like this, I realize I have not spoken in a while about our organic cost per acquisition, and customer lifetime value.

We talked for many years about customer acquisition costs below $100. Over the past couple of quarters, those have floated up to just over $100, for several reasons. Primarily, our unattributed -- or word of mouth (or free) -- adds have dropped as carriers have offered better value and become better at retaining their current subscribers, and as cable companies have become new entrants into the market. So a greater percent of our adds are coming at a price. We have also found, along with most other advertisers, that Google and Facebook have become more expensive, with more competition for clicks, as well as less effective, due to increased privacy protections. The good news is this is still well below customer lifetime value.

So the financials are still very attractive, and the challenges are still the same: grow awareness, grow consideration, and grow adds, ideally through channels that are both targeted -- reaching our unique prospects with our unique value proposition -- and scalable.

In our carrier and guidance update a few weeks back, and subsequent question and answer broadcast, I talked about our new deal with Verizon, our extended deal with Sprint, our decision to leave T-Mobile, and our upcoming eighteen-month challenge to migrate our 160,000 T-Mobile subscribers to our Sprint and Verizon networks. I would encourage everyone to refer back to those transcripts for all the details on these important developments.

With the Sprint/T-Mobile merger now moving ahead, and DISH entering the mix as a fourth carrier, there are still some uncertainties. We will see how T-mobile approaches our existing Sprint agreement. We will see what DISH's plans are, in both the short term and the long term.

Regardless, with significantly lower guarantees in 2020 and virtually no existing guarantees in 2021, we feel we have created the maximum flexibility to allow us to focus on the Verizon integration, the T-mobile migration, and building a clear future for Ting Mobile.

After what feels like a LONG time waiting and negotiating, we are excited to get back to taking the Ting Mobile business to the next level. Loyal, happy customers and a profitable business are a great place to start.

Finally, **Ting Internet.**

First, the numbers. This quarter we added 1,100 customers. We passed over 5,700 new addresses with 1,700 of those additions now serviceable. The 4,200 unlit addresses are primarily in Centennial and Fuquay-Varina, and are awaiting completion of central facilities and electronics. This brings us to totals of roughly 8,800 active customers and 33,500 serviceable addresses.

We spent over $9 million in fiber capex in Q2 to build to those 5,700 plus addresses. I have talked about the fiber machine in terms of throughput and efficiency: how much we spend and how much it costs. This spend is our largest ever, beating the $7.7 million we spent in Q4 last year. And we have been able to scale that throughput without negatively impacting efficiency.

We also had our strongest quarter ever for Internet customer adds, breaking 1,000 in a quarter for the first time, and we expect to break that record again in Q4 as some of the above-noted passes become serviceable.

We also have some market milestones to report. The City of Westminster has completed the build of their network, and in Holly Springs, our originally planned build is completed. There will continue to be incremental serviceable addresses added in Holly Springs, as new residential developments in this growing community become occupied, but this is of course accretive, both adding to the profitability of the footprint and adding serviceable addresses at lower costs per pass.

The builds in Charlottesville, Centennial, Sandpoint and Fuquay-Varina are all progressing according to plan, and we’re building our first neighborhoods in Wake Forest. The pre-orders have been outstanding there, and reinforce our belief in the outsized demand for Ting in a thriving geographic region like North Carolina’s Research Triangle. In Fullerton, California, where our partner SiFi is building the network, construction is scheduled to begin in September.

As we get more experience building fiber and watching the financial flows, we continue to learn more about how to best evaluate this business. And as we do, we hope to be able to better communicate with investors about it.

Recently we have been digging more deeply into national costs. As a reminder, in the Ting Internet business we see revenue at a city level, a layer of costs at the city level, and another layer of costs at the national level.

As we have looked more deeply we have come to realize that a significant portion of these national costs are related to building networks, not operating them. Thus we have decided for our internal modeling, which is cash-on-cash modeling, to include them in the build costs and exclude them from the operating costs.

This means higher build costs, but also higher net margins over the long term. While we intend to share more of our learning as we progress, for now it looks like these national build costs add a little less than ten cents to every fiber capex dollar spent. This also further contributes to the cost advantage that we believe we have at scale in terms of servicing existing customers when compared to traditional telecom with their legacy systems and processes.

Each successive quarter further confirms our model: build costs are between $1,000 to $1,500 per serviceable address. Adoption is 20% after one year and is moving on a path to 50% after five. Customers are delivering $1,000 a year in gross margin. And every day we’re getting better at building efficiently, at generating demand, at signing up subscribers, and in setting up the organization to efficiently scale. All of which continues to give us great confidence in the potential of this out-sized, long-term growth opportunity.

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

Financial Results [Dave Singh, CFO]

Thanks Elliot,

Total revenue for the second quarter of 2019 was $84.1 million, an increase of 4% from $81.1 million for the second quarter of 2018. The increase was primarily driven by growth in the wholesale domains channel, as well as incremental contribution of the Ting Internet business, which were partially offset by lower revenue from our non-core domains portfolio and Ting Mobile.

Cost of revenues before network costs increased 1% to $54.9 million from $54.5 million for the same period last year, with the slight increase due primarily to the higher year-over-year revenue. As a percentage of revenue, however, cost of revenues before network costs decreased by 200 basis points to 65% from 67%.

Gross margin before network costs for Q2 increased 10% to $29.2 million from $26.6 million, or, as a percentage of revenue, increased to 35% from 33% for the same period last year.

I'll now review gross margin for each of the Domain Services and Network Access businesses.

Starting with Domain Services, gross margin for the second quarter increased 12% to $17.4 million from $15.5 million for Q2 of last year. As a percentage of revenue, gross margin for Domain Services for Q2 of this year increased to 29% from 27% for Q2 last year.

As a reminder, as a result of the purchase price accounting on the Ascio acquisition completed on March 18th of this year, overall Domain Services gross margin was negatively impacted by the amortization into revenue of the deferred revenue that was recorded at fair value at closing of the transaction. That had the impact of lowering overall Q2 gross margin for domains by approximately $0.7 million. That brings the cumulative impact for Q1 and Q2 of this year to approximately $0.8 million of the total impact of about $2 million, the majority of which will be reflected in our 2019 results.

Drilling down to the individual components of Domain Services, gross margin for the Wholesale Channel increased 20% to $12.7 million from $10.5 million for the second quarter of last year. As a percentage of revenue, gross margin for Wholesale increased to 25% from 22%. The increase on both an absolute dollar and margin basis is primarily due to the impact of the pricing realignment mid-way through last year and, to a lesser extent, the acquisition of Ascio.

Gross margin for Retail Domain Services increased 9% to $4.4 million from $4 million in Q2 of last year and, as a percentage of revenue, expanded to 50% from 48%.

Gross margin for Portfolio Services was $0.3 million, compared with $1 million in Q2 last year, but was up from $0.2 million in Q1 of this year. Again, this reflects the smaller size of the portfolio, and the resulting lumpiness of quarter-to-quarter revenue. As a percentage of revenue, gross margin was 67% compared with 83%.

Moving on to Network Access, gross margin for the second quarter of this year increased 8% to $11.9 million from $11 million in Q2 of last year. A $250,000, or 2%, decrease in gross margin from Ting Mobile was more than offset by a $1.1 million or 180%, increase in gross margin from Other Services, driven primarily by growth in the Ting Internet subscriber base. As a percentage of revenue, gross margin for Network Access increased to 50% from 45% in Q2 of last year, with gross margin percentage for Ting Mobile increasing to 49% from 47% and for Other Services increasing to 64% from 32%.

Turning now to costs, network expenses for the second quarter of 2019 increased 7% to $4.7 million, from $4.4 million in Q2 last year. The increase is primarily due to the higher amortization associated with the investment in the Ting Internet network.

Total operating expenses for the second quarter of this year increased 14% to $18.8 million, from $16.4 million for Q2 of last year. The increase is due primarily to the following:

- Workforce and third-party workforce-related expenses, which increased by $1.2 million, partially due to the acquisition of Ascio on March 18th; and to a lesser extent growth in Internet subscribers and the Ting Internet footprint;
- Marketing expenditures, which increased $0.3 million, related to higher spend on Ting Mobile;
- A $0.4 million increase from Ascio non-workforce related costs, including facilities, transitional services, and technology;
- A $0.6 million increase in other costs, including credit card fees, as well as investments in tools and technology to support our growing employee base;
- Amortization of intangible assets, which increased by $0.4 million related to the set-up of intangible assets related to the Ascio brand, customer relationships, and technology totalling $14.6 million. Note that these assets will be amortized over 7 years.

I'll also note that the increases I listed were partially offset by positive foreign currency impacts in the quarter, where we had a neutral impact in Q2 2019 related to mark-to-market remeasurements for our currency forward contracts that do not qualify for hedge accounting, compared a $0.1 million loss in Q2 of last year. In addition, we experienced a foreign exchange gain on the revaluation of foreign denominated monetary assets and liabilities, which had the impact of decreasing our expenses $0.4 million on a year-over-year basis.

As a percentage of revenue, total operating expenses increased to 22% from 20%.

Net income for the second quarter of 2019 was $2.6 million, or $0.25 cents per share, compared with $3.6 million, or $0.34 per share, for the same period last year.

Adjusted EBITDA increased by 3% to $11.5 million from $11.2 million for Q2 last year. As I mentioned earlier, the impact of the fair value adjustment on deferred revenue related to the Ascio acquisition was about $0.7 million this quarter.

Turning to our balance sheet and cash flows, cash and cash equivalents at the end of the second quarter of 2019 was $12 million compared with $11 million at the end of the first quarter of 2019, and $11.2 million at the end of the second quarter of last year. The increase in cash from the end of Q1 of this year was primarily the result of the generation of $7 million in cash flow from operations, as well as advances on our loan facility of $7.4 million, which were partially offset by our investment during Q2 of an additional $10.4 million in property and equipment, primarily for the Ting Internet build out, and an advance payment of $2.5 million for the acquisition of FreedomPop subscribers with the remaining purchase price to be paid in Q3 2019.

Deferred revenue at the end of the second quarter was $157 million, down slightly from $159 million at the end of the first quarter of this year, and up from $152 million at the end of the second quarter of last year. The year-over-year increase is due primarily to the acquisition of Ascio in March of this year.

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

Closing Remarks [Elliot Noss, CEO]

We are now halfway through 2019 and are able to turn into the back half of the year with clarity in mobile and a full plate. We have a clear path in each of our three lines of business. Each is lucrative, each provides fantastic visibility and reliability and each provides opportunities for growth, with Ting Internet of course providing the greatest growth potential.

First, I wish to reiterate our guidance provided earlier in this quarter, of $52 million in cash EBITDA for 2019.

Next, in the domains business we are clearly the scale player with the low margins and high switching costs in this business providing a great moat around it. You can see the value in the incredible predictability and reliability in this business. This low beta is especially attractive in a yield-starved world.

We are now at the point in domains where old technology barriers have been removed and we are seeing operating efficiencies and opportunities to pursue new service offerings in a meaningful way for the first time in years.

We are likely to have mostly moved on from owning our own portfolio of premium domain names by the end of the year, but we retain our collection of surname domain names, which we consider a valuable strategic asset.

More efficient operations with new opportunities for the first time in years has us feeling good about the domains business.

In the Ting mobile business we can finally move beyond some of our carrier headwinds and focus forward. We will be moving forward without significant carrier guarantees after this year. And we move forward knowing we have one of the most efficient MVNOs in the world, with high gross margins and high net profitability. We are not trading profits for growth, as we have a business that is not valued on raising a higher next round of financing or trading on a multiple of revenue, but rather on the basis of its ability to generate cash and grow that cash generation.

We do this with a business that is beloved by its customers, receiving high marks and high praise from Consumer Reports yesterday for the fourth year in a row. We do it in a way that is unique in telecom around the world and we do it at a time when there is a lot of upheaval in the US mobile market. And upheaval always favours the nimble.

And finally Ting Internet.

Everyone working on fiber and all our investors know that fiber-to-the-home is a long-term business. A lot of capital is deployed up front, and the returns flow from it for a long, long time with the operating effort going into that flow generally getting easier and easier.

We are now starting to reach the point where we are seeing the returns from our earliest investments. We are seeing Charlottesville and Holly Springs generate positive cash flow while improving penetration and, most importantly, incredibly high customer satisfaction.

We have now moved from the earliest stages in Fuquay Varina and Centennial to the point where they start to kick in customers and the cash flow that inevitably follows. And remember, Centennial alone has almost as many projected serviceable addresses as our four previously launched Ting fiber towns combined.

The fiber opportunity looks like what we always believed it to be, huge and profitable with a unique runway due to a particular macro environment. We can also share that our execution in this area is strong and our learning rate continues to be extremely rapid. The latter point is likely more important than the former in the long term. Our outlook for the fiber business is brighter than ever and we continue to demonstrate our ability to play a substantial role in the buildout of high-speed Internet in the U.S., which we view as a once-in-a-century telecom transition.

With two businesses with strong and reliable cash generation, and interesting growth opportunities which feed a third business that has a long, long runway for sustained, outsized growth and a unique opportunity to deploy capital profitably, we consider ourselves to be in a great position.

And with that, I look forward to your written questions and exploring areas that interest you in greater detail. Again, please send your questions to **ir@tucows.com.**

Thank you.
