



Q4 2019 Management Remarks Transcript

Introduction [Monica Webb, Director, Market Development and Government Affairs]

Welcome to Tucows' fourth 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 until Tuesday, February 18th. Management will address your questions directly, or in a recorded audio response and transcript that will be posted to the Tucows website on Tuesday, February 25th at approximately 4 p.m. eastern time.

We would also like to advise that the updated Tucows Quarterly KPI Summary, which provides key metrics for all of our businesses by quarter since Q1 2018, is available in the [Investors section of the website](#), along with the updated Ting Build Scorecard and Investor Deck.

Now for management's prepared remarks:

On Wednesday, February 12th, Tucows issued a news release reporting its financial results for the fourth quarter ended December 31, 2019. That news release, and the Company's financial statements, are available on the company's website at tucows.com, under the Investors section.

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, President and Chief Executive Officer]

Thanks, Monica. I'll begin our remarks with a review of the fourth 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.

Now on to the quarter. The fourth quarter once again showed the consistency in the Tucows business. Total revenue increased slightly to \$85.9 million from \$85.6 million for Q4 the prior year, although I will note that Q4 2018 did include significantly larger bulk sales revenue from our Domain Portfolio. Excluding the impact of the larger bulk name sales in the fourth quarters of 2018 and 2019, revenue increased 3% year over year. That took total revenue for 2019 to \$337 million.

Gross margin dollars for Q4 2019, again, excluding the impact of the bulk domain sales, as well as correcting for the non-cash impact of the purchase price accounting treatment for the Ascio transaction, increased 5%. Without accounting for these impacts, the “as reported” number was a decline of 4%. Total gross margin dollars for the year, excluding the Ascio purchase price accounting impact, increased 7%, and including the Ascio purchase price accounting impact, increased 5%.

Adjusted EBITDA was \$16.2 million compared with \$16.6 million for Q4 of 2018. And net income was \$5.8 million, up from \$4.4 million in Q4 of 2018. That took adjusted EBITDA for all of 2019 to \$51.9 million from \$50.1 million, and net income for the year to \$15.4 million, compared with \$17.1 million in 2018. Finally, Cash EBITDA for the year was \$52.7 million, ahead of our guidance of \$52 million.

Domains

Our Domains business delivered another quarter of solid performance, with our success in managing this business for gross margin contribution and profitability being once again evident in the results.

In our Wholesale channel, gross margin dollars increased 18% year-over-year, with Domain Services up 17%, and Value Added Services up 20%.

For Domain Services, the majority of the increase -- approximately 85% of it -- was generated by the Ascio resellers we acquired last March, with the remainder being driven by the pricing increase implemented in 2018. And again, I will note the Ascio contribution was dampened by the accounting treatment.

Total wholesale registrations for the fourth quarter increased 6% year-over-year to 3.8 million from 3.5 million, driven mainly by the Ascio acquisition. Adjusting for the transactions contributed by that acquisition, total registrations were down about 3% year-over-year, primarily from expected declines for Enom resellers. Growth in gross margin dollars during the quarter is indicative of the benefit of focusing on higher-quality wholesale customers. The Wholesale channel renewal rate continued its above-industry average performance and improved to 78%.

For Value Added Services, the 20% year-over-year increase was the result of the changes we made in the expiry stream process early in Q2 of 2019 -- our third consecutive quarter of solid year-over-year growth since we made those changes.

In the Retail Domains channel, total registrations for the fourth quarter were down 5% year-on-year to approximately 345,000, compared with 362,000 in Q4 2018. The decline was again mainly in the high-priced Enom brands. Gross margin dollars however, were up 5%.

The Retail renewal rate came in again at a very healthy 80% for the quarter, also continuing to be solidly above the industry average.

The fourth quarter saw the final bulk sale of our Domain Names Portfolio. This sale contributed to gross margin for the Portfolio business of \$1.5 million.

As a reminder, beginning with our Q1 reporting in May, our year-over-year Domains results will reflect our exit from the Portfolio business.

At the end of the year, and with the completion of our exit from the Domains Portfolio business, I wanted to take this opportunity to highlight the strong performance of the core of the Domains business over the past number of years. Over the last four years -- from 2015 to 2019 -- a series of opportunistic and selective acquisitions have allowed us to take advantage of the scale and efficiency in our business, as well as our focus on maximizing profitability. During that period, we more than doubled the gross margin dollars for the Wholesale Domains channel. For the same period, we expanded gross margin dollars for the Retail Domains channel by two-and-a-half times. And we did it while deploying over \$100 million in capital -- and meeting our lofty IRR targets.

Ting Mobile

Now Ting Mobile.

Annual service revenue was down 2.2% in 2019 versus 2018. Service revenue for Q4 was down 4% versus Q4 a year ago, and down 4.7% compared to last quarter. Margin relative to revenue will reflect the carrier penalties that we have discussed before and that we expect to be rid of in 2020 and beyond. With those penalties, annual gross margin on service revenue was down 8.8% in 2019 versus 2018. Gross margin on service revenue for Q4 was down 15% versus a year ago, and down 10% sequentially. As noted many times now, this corrects and improves in 2020.

Our initial steps to migrate away from T-Mobile before eventually extending that relationship through an MVNE did also hit our 2019 financials, as we had begun offering service credit incentives and device subsidies to move subscribers from T-Mobile to Sprint. I believe that money will still be well spent as we enjoy better margins on the Sprint side.

We finished the year with just under 160,000 accounts and just over 289,000 subscribers. We lost about 3,000 accounts and 7,000 subscribers in all of 2019, just about 2% on each of those numbers. In Q4, which has become our weakest quarter perennially, with holiday spending and device promotions that tend to hurt us way more than help us, we lost about 6,500 accounts and 4,700 subscribers.

I should mention that our stop and start on T-Mobile and lead up to Verizon forced us to temporarily pull Ting SIM cards out of retail, most notably Target and Best Buy. That step backwards in distribution impacted our Q4 adds and we will now have to wait for regular cycles when those retailers refresh their inventory in order to get our SIM cards back on shelves later this year.

Churn for Q4 was 3.66%, up from 3.36% in Q3 and 3.11% in Q4 a year ago. Without the recently acquired FreedomPop customers, who were still churning at higher levels during their first few months, Q4 churn on the base was right in line with Q4 the last couple of years.

One metric that was striking as we looked back at 2019. 55% of our gross subscription adds came from existing Ting accounts adding lines. Our gross subscription adds on existing accounts have increased in each of our eight years and nearly 40% of our accounts now have more than one active device. While we would love to feel as good about our pipeline of brand new customers, it does feel really healthy to be able to count on existing customers to not only stay as long as they do, but to continue to bring us business.

I am also delighted to report that we quietly added the Verizon network to our offering just this week. We will make sure everything is working properly for a few weeks before promoting it. This portfolio of carriers puts us in a fantastic position now to optimize customers' network coverage, cast the widest possible net on device compatibility, reduce our carrier costs, and maximize our carrier incentives. It will be exciting over the next few months to start to see how this impacts our ability to convert and retain customers, and how it impacts the margins we earn on those customers.

As I have said before, for nearly eight years now, many of our Ting prospects and customers have had to weigh a lower phone bill and a better customer experience against second-choice network coverage. Now, with the largest and best network in the country, the choice to switch to Ting or stay with Ting just got easier.

While our network offering improves and our customer experience just keeps getting better, I should acknowledge that our competitors' pricing has improved too. And that is not just at the carrier level. We see MVNOs with rate plans that would seem impossible at an MVNO cost structure. And we see them spending almost carrier-like advertising dollars to bring customers onto those plans. We can boast the sustainability of our model. We can speculate that these

marketing efforts are often made with an eye towards selling to an incumbent. But the fact is that the competitive landscape does make it tougher for us to acquire customers today.

With the Verizon integration nearly behind us, we hope to finally turn our attention to the customers whose usage and approach to budgeting best fit our offering. We will continue to research and experiment with offerings that might drive financial growth. We continue to believe that there is white space in this category and that we have the customer satisfaction, the brand salience, the technical agility, and the financial stability to own it.

Just this week, a judge ruled in favor of the Sprint-T-Mobile merger and against the state attorney generals. We do not expect any impact on our supplier relationships in the short term. We will certainly be curious to see what changes over time. Regardless, with a diverse portfolio of networks, favorable contracts, a technical platform that is admired throughout the industry, and all the strengths in our cost structure and customer base, we think we have put ourselves in a good position to roll with change. And it never hurts to make money while doing so.

Ting Internet

Moving to Ting Internet, the fourth quarter saw continued steady progress across all metrics, with the ongoing efforts to convert passed addresses to serviceable starting to be resolved.

We spent \$8 million in fiber capex in Q4, which is in line with our investment objectives.

We passed 3,400 new addresses, and 2,200 became serviceable, bringing us to a total of 36,400 serviceable addresses, with an additional 17,000 passed but not yet serviceable. That's fewer new addresses passed than the last few quarters, primarily due to reallocating our construction resources. We redeployed a crew that had recently completed a large residential build in North Carolina over to network transport construction to connect two of our regional markets. And in Charlottesville, we moved crews from residential neighborhood construction to installation of high-priority enterprise customers. Both decisions link back to my discussion in Q3 about using our experiences to iterate our organizational planning, with particular emphasis on structuring construction to scale.

Although we're starting to make progress, we continue to have a backlog of passed addresses waiting to be converted to serviceable pending the completion of our data center and other central facilities over the next few quarters. The markets impacted are Centennial, Wake Forest, and up until recently, Fuquay-Varina, whose central office is now operational, and we're now starting to install the backlog of pre-ordered subscribers there. As we discussed on the Q3 call, we have taken steps organizationally to address the additional complexities of facilities construction.

700 Internet subscribers were added in Q4, a modest increase -- but that's also constrained by the delays in making addresses serviceable. That brings us to roughly 10,200 subscribers.

Additionally, we closed our acquisition of Cedar Networks, in Colorado, on January 1st. The Cedar footprint and business bring 6,400 new serviceable addresses and 1,400 additional subscribers to Ting, most of which are enterprise customers and prominent local anchor institutions. The integration of Cedar into Ting Internet, from a people, systems, and network perspective, is on schedule. We are well into planning fiber expansion within Cedar's footprint starting this year.

And an update on the progress of our two private fiber infrastructure partners -- SiFi Networks, deploying in Fullerton, California, and Netly Fiber, building in Solana Beach, California.

Both began construction in December and are making progress, and both tell us they are looking at lighting the first Ting customers on their networks in late Q2 or early Q3.

2019 was an excellent year for Ting Internet, as we start to see our assumptions for the fiber business being affirmed. Year-over-year, our Internet subscribers have grown by a robust 46%, reflecting strong pent-up demand. Our gross margin is up year-over-year by 44%. And our organization has scaled to meet aggressive build targets: our passed addresses, year-over-year, are up 60%. And even with the additional organizational work and delays from our central office construction, serviceable addresses have grown by nearly 30% year-over-year.

And our pipeline remains full. Year-over-year, our potential serviceable address list increased by 53%, as we continue to add new Ting towns to our roster. And that's before we account for Cedar Networks, adding even more serviceable addresses. Plus we have no shortage of prospects. Cities, counties and residents continue to approach us asking for Ting Internet to build in their communities, and much of our work goes into growing our capacity to accommodate as many new opportunities as we can successfully manage.

Heading into 2020, it feels more clear than ever that we entered this business at the right time, and for the right reasons. We brought core competencies from our ISP roots, from Domains and from Ting Mobile, and most importantly, we continue to learn, and evolve the operation in order to scale, and to set the stage for the long-term growth trajectory of the Ting Internet business.

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, Chief Financial Officer]

Thanks Elliot,

Total revenue for the fourth quarter of 2019 was \$85.9 million compared with \$85.6 million for the fourth quarter of 2018, with growth in the Wholesale Domains channel, primarily due to the acquisition of Ascio, as well as growth in the Ting Internet subscriber base, essentially being

offset by lower revenue from the Domains Portfolio and lower revenue from Ting Mobile. Specifically, I will note that, while the fourth quarter of both 2019 and 2018 benefitted from bulk sales from the Domains Portfolio, Q4 of 2018 saw a much larger top line contribution in this regard, by about \$2 million. Outside of these bulk Portfolio sales, total revenue for Q4 2019 was up 3% year-over-year.

Cost of revenues before network costs increased 3% to \$55 million from \$53.5 million for the same period of 2018, with the increase due primarily to higher revenues, when excluding the impact of the bulk portfolio sales in both quarters. As a percentage of revenue, cost of revenues before network costs increased by about 140 basis points to just over 63%, from just under 62%.

Gross margin before network costs for Q4 decreased 4% to \$30.9 million from \$32.1 million, or, as a percentage of revenue, decreased to 36% from 37% for the same period the prior year. Again, I will note that gross margin for Q4 of 2018 benefitted from \$2 million more in bulk Portfolio sales, with these sales generating approximately 90% gross margin.

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

Starting with Domain Services, gross margin for the fourth quarter was down slightly from Q4 of 2018 at \$19.4 million, compared with \$19.6 million. As a percentage of revenue, gross margin for Domain Services fell slightly to 31% from 32%. Excluding the impact of the much larger bulk Portfolio sale in Q4 of 2018, gross margin was up 10% year-over-year.

As a reminder, as a result of the purchase price accounting on the Ascio acquisition completed on March 18th, 2019, 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 Q4 gross margin for the Domains business by approximately \$0.5 million, which brings the cumulative impact for the 2019 year to \$2.5 million. Going forward, the impact will be diminimums and we will not be separating it out.

Within the Domain Services business, gross margin for the Wholesale Channel increased 18% to \$13.2 million, from \$11.2 million for the fourth quarter of the prior year. As a percentage of revenue, gross margin for Wholesale increased to 26% from 24%. The increase, on both an absolute dollar and margin basis, was primarily the result of the Ascio acquisition, and to a lesser extent the pricing alignment implemented in the first half of last year.

Gross margin for Retail Domain Services increased 5% to \$4.7 million from \$4.5 million in Q4 of 2018, and as a percentage of revenue, ticked up to 54% from 50%.

Now onto the Portfolio. As Elliot discussed, the bulk sale during the fourth quarter marked our exit from the Portfolio business. That sale contributed to gross margin for Portfolio Services of \$1.5 million, compared with \$3.9 million for Q4 of 2018, which again, benefitted from larger bulk

sales. As a percentage of revenue, gross margin was essentially unchanged from Q4 of the prior year, at 90%.

Turning now to Network Access, gross margin for the fourth quarter of 2019 decreased 7% to \$12.2 million, from \$13.1 million in Q4 of 2018. A \$0.7 million, or 34%, increase in gross margin from Other Services, driven primarily by growth in the Ting Internet subscriber base, was more than offset by a \$1.6 million, or 15%, decrease in gross margin from Ting Mobile. As a percentage of revenue, gross margin for Network Access was 50% compared with 53% in Q4 of 2018, with Ting Mobile down to 45% from 49%, and Other Services ticking up to 90% from 87%. A reminder that the recent Cedar transaction closed on January 1st so our results do not yet reflect the impact of their operations.

Turning now to costs, network expenses for the fourth quarter of 2019 increased 12% to \$4.9 million, from \$4.4 million in Q4 of 2018. The increase is primarily due to higher amortization resulting from our buildout of the Ting Internet network.

Total operating expenses for the fourth quarter of 2019 decreased 8% to \$16.1 million from \$17.5 million, for the fourth quarter of the prior year. The decrease is due primarily to the following:

- Excluding the impact from the acquisition of Ascio on March 18th, workforce and third-party workforce-related expenses, decreased by \$0.9 million driven primarily by a \$1.3 million cumulative adjustment for capitalizing development costs associated with our domains platform work. In the past our domain platform work was focused on maintenance, bug fixes, and minor upgrades. With the significant work and new tools being built, we determined capitalizing a portion of these costs was appropriate. The adjustment this quarter represents the full impact of the 2019 costs and going forward the impact will be reflected quarterly. This reduction was offset by a workforce expense increase related to the growth in Internet subscribers and the Ting Internet footprint.
- Ascio related expenses added \$0.9 million to the quarter, of which \$0.6 million were workforce related and \$0.3 million were related to facilities, and technology.
- Marketing costs decreased by \$0.8 million primarily related to Ting Mobile and Roam mobility relating to a reduction in marketing credits issued, due to lower subscriber additions, and lower digital marketing expenditures. I should note for the full year, our overall marketing expenditures were comparable year-over-year.
- Amortization of intangible assets increased by \$0.8 million, which related primarily to the set-up of intangible assets related to the Ascio brand, customer relationships, and technology totalling \$15.1 million. Note that these assets will be amortized over 7 years.
- Other expenses, including facility costs, travel and professional fees decreased \$0.3 million.
- And lastly, there was a \$1.1 million net decrease in expenses related to foreign exchange

impacts. Specifically, we had a gain of \$100K in Q4 2019 related to mark-to-market remeasurements for our forward currency contracts that do not qualify for hedge accounting, compared to a loss of \$0.2 million in Q4 of last year, resulting in a year-over-year expense decrease of just under \$0.3 million. In addition, we experienced a foreign exchange gain on the revaluation of foreign denominated monetary assets and liabilities of \$0.1 million compared to a loss of \$0.7M in the fourth quarter of 2018, which had the impact of decreasing our expenses \$0.8 million on a year-over-year basis.

As a percentage of revenue, total operating expenses decreased to 19% from 20%.

Net income for the fourth quarter of 2019 was \$5.8 million, or \$0.55 per share, compared with \$4.4 million, or \$0.42 per share, for the same period last year, driven by a lower effective tax rate in Q4 2019.

Adjusted EBITDA was \$16.2 million, down slightly from \$16.6 million for Q4 of 2018. As I mentioned earlier, the impact of the fair value adjustments on deferred revenue related to the Ascio acquisition was about \$0.5 million this quarter. For the full year, our Adjusted EBITDA was \$51.9 million as compared to \$50.1 million in 2018.

Turning to our balance sheet and cash flows, cash and cash equivalents at the end of the fourth quarter of 2019 was \$20.4 million, up from \$12 million at the end of the third quarter of 2019, and up from \$12.6 million at the end of the fourth quarter of 2018. During the quarter, we generated \$13.2 million in cash from operations and advanced \$12.0 million on our loan facility, mostly to fund the acquisition of Cedar networks which closed on Jan 1, 2020, which were partially offset by our investment of an additional \$12.9 million in property and equipment, primarily related to the Ting Internet build out, as well as a \$3.5 million repayment of our loan facility.

Deferred revenue at the end of the fourth quarter was \$149 million, down from \$154 million at the end of the third quarter of this year, and up from \$144 million at the end of the fourth quarter of last year. The year-over-year increase is due primarily to the acquisition of Ascio in March of 2019.

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

Closing Remarks [Elliot Noss, President and Chief Executive Officer]

Thanks Dave.

There were no share repurchases in the fourth quarter, which means our total repurchases for the year were roughly \$5 million, representing nearly 102,000 shares at \$48.95 a share. Today, we announced another open market buyback -- our 13th since 2007. This year's program has the

same terms as that of last year, allowing us to repurchase up to \$40 million of our shares through the next 12 months.

Last quarter, I provided a high level view of our outlook for 2020. As a reminder, I discussed the impact of our exit from our Domains Portfolio business and the benefit of the changes to our Ting Mobile carrier relationships roughly offsetting each other, and that otherwise, we expect the Domains and Ting Mobile businesses to be more or less flat.

With that noted, we are providing Adjusted EBITDA guidance for 2020 of \$50 million. To be clear, that's Adjusted EBITDA, not cash EBITDA, which is the metric we've used to provide guidance until now. For reasons discussed too many times now, it is a regulatory burden to discuss cash EBITDA, so this year we are making the change. Really, the only material distinction between the two is the net deferred revenue provided by the Domain Name business. In 2020, that is expected to be in the range of \$1.5 million to \$2 million, meaning the year will be essentially flat to 2019.

At a high level, the growth in mobile is due primarily to the absence of excessive carrier penalties making up for the end of portfolio sales. Fiber contribution will improve from 2019 as well, but will still be a negative contributor before moving to materially contributing in 2021 and 2022. Most importantly, Fiber is meeting all of our lofty expectations both on an aggregate and market-by-market basis.

We believe that fiber will be ubiquitously deployed as future-proof communications infrastructure -- and that fiber, by virtue of its technical superiority, will dominate the broadband category. We believe both the smart money and the data supports this.

In our February commentary, I am usually talking through the year ahead. In February 2020, I want to take this opportunity to briefly look at the decade ahead and share some thoughts about what February, 2030 might look like in telecom.

We enter 2020 with clear signs of significant change in US telecom.

With the Sprint-T-Mobile merger getting the green light this week, Dish is poised to become a fourth competitor with loads of spectrum and nothing to lose.

In fixed Internet we see a bidding war for Cincinnati Bell, a looming bankruptcy hearing for Frontier, discord between Windstream and Uniti, and the cable incumbents looking to extend the life of coax as long as possible.

We see more and more private equity and infrastructure funds seizing the opportunity by buying and building fiber assets.

And overriding both is the drive to end the separation between fixed and mobile Internet.

In the next decade we fully expect to see the table flipped over, and the US telecom environment looking very different in February 2030.

In thinking about our role in this world, more and more it looks like our platform will be as important as our customer relationships. The further we get into the exercise, the more it becomes clear that our biggest competitive advantage lies in our telecom software stack.

It appears to be providing significant advantages in operating expense relative to current operators, in both fixed and mobile.

It is important to remember that we are talking about the coming decade so please don't ask me about opportunities in this regard for the next quarter. We do believe that the software that telecom operators currently use is archaic and inefficient, like banks or insurance companies. And we believe that the advantage a modern platform provides at an operating level is a sustainable competitive advantage, like that provided by any platform that has leadership.

At the start of a new decade, and as we move closer towards Ting Internet materially contributing to the business in 2021 and beyond, the macro environment for US telecom, and the micro benefits of our current competitive situation have us more excited than ever for what is to come.

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@tu cows.com, and look for our recorded audio response and transcript to be posted to the Tucows website on Tuesday, February 25th at approximately 4 p.m. eastern time. Thank you.
