tucows

Tucows Q1 2020 Management Remarks Transcript

Introduction [Monica Webb, Head of Market Development and Strategic Partnerships]

Welcome to Tucows' first quarter 2020 management commentary. We have pre-recorded prepared remarks regarding the quarter and outlook for the Company. A transcript of the management commentary is also available on the Company's website. In lieu of a live question and answer period following the remarks, shareholders, analysts and prospective investors are invited to submit their questions to Tucows' management via email at ir@tucows.com until Wednesday, May 13th. Management will address your questions directly, or in a recorded audio response and transcript that will be posted to the Tucows website on Wednesday, May 20th 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 for the last five quarters, as well as 2018, 2019, and year-to-date, 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 Thursday, May 7th, Tucows issued a news release reporting its financial results for the first quarter ending March 31, 2020. 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 with a review of the business in the context of COVID-19, and then a more detailed review of the first quarter across business units. Dave Singh, our Chief Financial

Officer, will then review the first quarter financial results in detail, and I'll return for some concluding comments.

First, we are fortunate that domain registration and mobile phone service can be effectively delivered from our laptops and servers, and are both absolutely central to how people are connecting and transacting today. And, while fiber-to-the-home requires a physical component, it is also experiencing an upsurge in demand. The state of our business is thankfully very strong.

We've talked for years about how conservative, consistent, resilient and efficient our business is. On mobile, over half our subscribers have been with us more than three years. On fiber, our first glimpse at churn rates points to incredibly long customer lifetimes. On Domains, we have thousands of active resellers who have remarkably been with us for fifteen or more years. We run on recurring, automated payments from a large, diverse, global portfolio of loyal customers. We acquire a customer once and enjoy returns for years. That has never felt safer and healthier than it does right now.

Further, well prior to the current situation, we had already moved to a distributed workforce and virtual work processes. Our meetings were already on video calls and our documents, spreadsheets and presentations on G-Suite. Our perpetual chat is on Slack. Our product backlog is in Jira and our projects in Wrike. Support reps help customers from anywhere. Senior leaders sit in Los Angeles, Copenhagen, Portland, Bonn, Oakland, and Amsterdam -- nowhere near head office. So, with the exception of fiber installs, there was very little adjustment or interruption when our employees moved entirely to work from home.

The domains business has seen the most remarkable immediate impact, which will not really show up until the second quarter. New domain registrations are way up in the past month or so. We are seeing first-hand the rush for offline businesses to market, transact and fulfill online. We are seeing years of economic transformation jammed into weeks or months.

Ting Mobile is a window on changing habits. As has been reported elsewhere, cellular data usage is down with people on Wi-Fi all day -- and voice usage is up, as people check on friends and family. So far, these seem to balance each other out in our monthly margin. Our rate plan, where customers only pay for what they use, is, in fact, the perfect mobile plan for a population that is currently immobile. This seems to be reducing churn as our own customers are the first to recognize it. But then, adds also seem to be suffering as people are perhaps just doing less switching overall. You will recall we acquired a small business called Roam Mobility a few years ago that services Canadians making short trips to the US. That business, which is included in our Mobile Services financials, has, with closed borders, grinded to a halt. We have also lost several thousand low margin subscribers on a handful of business accounts in the entertainment sector. All in, it is just fine.

Ting Internet is experiencing an increase in demand and short term challenges in fulfilling it. Fast, symmetrical Internet access has never been so coveted across households, enterprises, healthcare, education, local governments and others. However, it is not business as usual. It takes thoughtful creativity to deliver that service to new customers while keeping them, and our front-line employees, safe. Our network construction, perhaps the most important variable in the company, has managed to progress with some adjustments as our contractors adapt to social distancing practices.

Across all our businesses, I have been so proud of how we have served our employees, our customers and our communities. We have been forgiving to small businesses who have needed extra time or some relief on their monthly bills. We have offered guidance to our readers and followers on everything from videoconferencing to telehealth. In our Ting fiber towns, we quickly deployed free drive-up Wi-Fi hotspots that have helped kids do their homework, enabled workers to telecommute, and facilitated community members' access to critical healthcare, government services, and loved ones, all from the safety of parked cars. We have stepped up hiring in customer service where we could afford to run a bit heavy in a time when people need work.

Again, we recognize that we are fortunate to have such a healthy business and we respect that our services are more essential than ever. We have tried to behave accordingly.

Q1 Results Summary

Now, on to the results. The first quarter was a very solid start to 2020. Total revenue increased 6% year-over-year to $84 million, while gross profit increased 11%, with increases in each of the businesses. Net income increased just over 1% year-over-year to over $2.8 million, or $0.27 a share, while adjusted EBITDA increased 34% to $12.7 million with increased contribution from all three lines of business. Cash flow from operations was $14.1 million, up 57% from the first quarter of last year, or $11.2 million, up 24% when normalized for the collection of a receivable in connection with the termination of our T-Mobile relationship.

Domains

In our Domains business, the first quarter again reflects the consistency and profitability of this business, as well as our success growing with total gross margin dollars increasing 20% year-over-year. As noted at the outset, while the Domains business is seeing a marked uptick in transaction volumes amidst the pandemic, the first quarter was not materially impacted.

For Domain Services, gross margin dollars increased 23%, with approximately 70% of that generated by the Ascio resellers we acquired at the tail end of the first quarter last year. The remaining 30% was driven by organic growth in the rest of the Domains business.

Total wholesale registrations for the first quarter increased 5% year-over-year to 4.3 million from 4.1 million, driven mainly by the Ascio acquisition. Adjusting for the transactions contributed by Ascio, total registrations were down about 3% year-over-year, consistent with recent quarters, and again, due primarily to the expected declines for lower-margin volumes with certain Enom resellers. The renewal rate for the Wholesale channel was 78% -- consistent with recent performance -- and again, solidly above the industry average.

For Value Added Services, we saw our fourth consecutive quarter of year-over-year growth in gross margin dollars, up 16% from Q1 last year, following the changes we made to the expiry stream early in Q2 of 2019. Of course, as we come up on a full year since the expiry stream changes, the year-over-year comparisons will no longer be as marked.

Our Retail Domains channel saw improved performance in Q1 with total registrations up very slightly, compared to the same period a year ago at 421,000, following a few quarters of being down comparatively year-over-year. Gross margin dollars decreased by 2%, as high-priced Enom names naturally churned out.

The renewal rate for the Retail channel in Q1 was also solidly above the industry average at 79%.

In the last few weeks we have seen a significant bump in transactions as businesses globally try to quickly move online, and as displaced workers look to entrepreneurship as the next stage in their career paths. We saw this begin to emerge in late March and it is still going strong. With tens of thousands of resellers and millions of end user customers, our Domains business has proven resilient through several economic cycles, but we are seeing something singular in this current, unprecedented environment. It feels like years of change being crammed into weeks or months. This is more interesting for what it says about the economy than it is material to our business, as new registrations make up only 20% of total transactions historically.

Ting Mobile

Now Ting Mobile.

Service revenue for Q1 was down 2.9% versus Q1 a year ago, and 4.4% compared to last quarter. However, gross margin on service revenue for Q1 was flat versus a year ago and up 7%

sequentially. This lift in gross margin reflects the more favorable guarantees we negotiated across carriers and should continue throughout the year.
We finished the quarter with just under 154,000 active accounts and 272,000 active subscribers, a loss of about 6,000 accounts and 17,000 subscribers with the subscriber loss tied to a small number of very low-contribution entertainment sector customers.

As mentioned last call, we are now live with Verizon, and we have quickly seen the largest share of our subscriber adds going to that network. That trend, in addition to network switches within the existing base, should further bolster our margin over time. Again, with the extension of our T-Mobile offering at a favorable guarantee, there is no longer the same urgency to migrate customers to Verizon. Instead, we can do so thoughtfully and inexpensively as it suits the customers' needs, and optimizes our own margins and incentives.

Our quarter was not without some carrier drama though, as T-Mobile finally officially communicated that it would no longer be allowing a large class of non-LTE devices to be activated on the network starting in June, and will be deactivating those devices already on the network by the end of the year. As we are more heavily reliant on BYOD than most mobile phone services, this will be a challenge to both adding customers and dealing with existing customers who have those older devices in hand. So we will be devoting some energy to getting these incoming and existing customers to upgrade their devices and will have the opportunity to nudge them toward Verizon in the process.

Churn for Q1 was 3.17%, down from 3.66% in Q4 and up from 2.83% in Q1 a year ago. It is worth nothing that March saw our lowest monthly churn rate in over three years as the FreedomPop base continued to normalize, and our quarantined customers started seeing the benefit of paying for just the cellular data they used. We have seen that continue in April.

As you know, the T-Mobile and Sprint merger completed this quarter. It is too early to see any impact yet but we are keeping an eye on what Dish might bring to both the retail and wholesale markets as the new owner of Boost Mobile and the eventual fourth network.

Ting Internet
Moving on to Ting Internet, the first quarter showed continued progress across all metrics, despite the impacts of COVID-19 towards the tail end of the quarter, which I'll discuss shortly. We spent $7.6 million in fiber capex in Q1. This was slightly less than anticipated, due to reduced capitalized labor, another impact of COVID-19 on the business.

We passed 2,800 new addresses, and 2,600 became serviceable in Q1, bringing us to a total of 45,400 serviceable addresses. The addition of 9,000 serviceable addresses to our Q1 totals was primarily due to serviceable addresses added from the Cedar Networks footprint, an acquisition that closed on January 1st of this year. We are also continuing to narrow the gap between passed and lit addresses with the lighting of addresses in our North Carolina footprint, and work completing facilities to light accumulated passed addresses in both our Centennial and Wake Forest markets.

As of Q1, Ting is now at 11,600 Internet subscribers, 600 of which were added in Q1 from existing Ting markets, plus nearly 800 fiber subscribers that came from our Cedar Networks acquisition. Ting markets' net subscriber additions were impacted by our temporary suspension of new installs through most of March. This slowdown, combined with the increased demand for installations driven by the pandemic, and the gap between passed and lit addresses, has created a significant backlog for us and we will be spending the next few months trying as hard as we can to work through it.

More on installs. Early in March, as the contagion risks began to quickly escalate, we proactively suspended new installations, unlike much of our competition. While taking a step back and looking at the installation process in detail, we temporarily created a review protocol for urgent installations and repairs, focused on health care facilities and health care workers.

We worked on innovating a safe installation solution that would return us to an acceptable cadence for the duration of the threat from COVID-19, while minimizing contact risk between customers and our teams. We began piloting that process on April 20th, and we now have an installation process that enables us to return to home and business installations at a time of unprecedented need for the Ting fiber service.

In all states where Ting Internet operates, there have been various levels of stay-at-home orders instituted. Internet access is deemed an essential service, and our construction activities fall under the qualification of essential infrastructure, so there have been no lawful impediments to our continued network build and installation of customers. Construction of our network has continued, while both Ting and our vendors employ social distancing and use of protective equipment. There have been some minor COVID-19-related delays as a result of reduced government capacity in processing permits and deployment of utility locating services in our Centennial market that have impacted our construction cadence there. We are leveraging relationships, and using workarounds where possible, but are adjusting our expectations to a slightly reduced pace of construction.

Additionally, as we reported in the Q4 update in February, we closed our acquisition of Cedar Networks, in Colorado, on January 1st. The time-sensitive elements of integration were completed on schedule, and we continue working on integrating Cedar customers into Ting, including streamlining the product lineup and standardizing operations. We launched a regional market in Cedar footprint, from Aspen to Carbondale, called Ting Roaring Fork, in February. We are also deep in the process of evaluating further market expansion opportunities from the Cedar footprint, and expect to have more detail in Q2.

Our two private infrastructure partners--SiFi Networks, deploying in Fullerton, California, and Netly Fiber, building in Solana Beach, California--continue to push ahead with their builds, and expect to possibly see their networks lit with Ting customers sometime in Q2 of this year. We continue to monitor their progress in those markets closely to account for delays from COVID-19 impacts.

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 first quarter of 2020 increased 6% to $84 million from $79 million for the first quarter of last year, driven by growth in the Wholesale Domains channel, which included the incremental contribution from the acquisition of Ascio completed on March 18th of last year, as well as growth in the Ting Internet subscriber base, which was up organically, but also benefited from the acquisition of Cedar Networks, that closed on January 1st of this year. This growth was partially offset by a small decrease in Ting Mobile revenue.

Cost of revenues before network costs increased 2% to $53.2 million from $51.9 million for Q1 of last year, with the increase due primarily to higher revenues. As a percentage of revenue, however, cost of revenues before network costs declined by nearly 300 basis points, to 63% from just over 66%.

Gross margin before network costs for the first quarter increased 14% to $30.8 million from $27 million, or, as a percentage of revenue, increased to 37% from 34% for Q1 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 first quarter increased 15% year-on-year to $17.9 million from $15.6 million in Q1 last year. As a percentage of revenue, gross margin for Domain Services increased to 30% from 28%.

Within the Domain Services business, gross margin for the Wholesale Channel increased 20% to $13.4 million from $11.1 million for the first quarter last 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 our focus on managing the business for gross margin, in particular, our focus on high quality customers.

Gross margin for Retail Domain Services decreased 2% to $4.2 million from $4.3 million in Q1 last year and, as a percentage of revenue, stayed flat at 50%.

Finally in Domains, our Portfolio business saw a gross margin increase of 81% year-on-year to $282,000, as we had a particularly good quarter for sales of Surnames.

Turning now to Network Access, gross margin for the first quarter increased 13% to $12.9 million from $11.4 million in Q1 a year ago. This was driven primarily by a $1.2 million, or 89% increase in gross margin from Other Services, which was the result of both the incremental contribution of the Cedar Networks acquisition completed January 1st, as well as continued growth in the Ting Internet subscriber base. The Cedar acquisition contributed approximately $1 million of gross margin this quarter.

The increase in Network Access gross margin was also helped by a $0.2 million, or 2% increase in gross margin from Ting Mobile primarily helped by lower carrier penalties in Q1 2020. As a percentage of revenue, gross margin for Network Access increased to 53% from 49% in Q1 of last year, with Ting Mobile increasing to 51% from 48%, and Other Services ticking up slightly up to 60% from 56%.

Turning now to costs, network expenses for Q1 2020 increased 29% to $5.6 million from $4.4 million in the same period a year ago. The increase is due to higher amortization resulting from our buildout of the Ting Internet network as well as the incremental impact from the Cedar acquisition.

Total operating expenses for the first quarter of 2020 increased 13% to $20 million from $17.6 million for the first quarter last year. The increase is due primarily to the following:

- Excluding the impact from the acquisition of Ascio on March 18th, 2019 and the Cedar acquisition on January 1st of this year, workforce and third-party workforce-related expenses, increased by $0.5 million, primarily from an increased workforce to support the Ting Internet build-out offset by a $0.3 million expense reduction from the capitalization of development costs associated with our domains platform work. In the fourth quarter of 2019, we commenced capitalizing the work efforts associated with our new tools being built.

- Ascio and Cedar related expenses added $1.1 million to the quarter, primarily workforce related.
- Marketing costs decreased by $0.5 million, primarily related to Ting mobile and Roam mobility driven by a reduction in marketing credits issued due to lower subscriber additions and to a lesser extent a reduction in business volumes at the onset of COVID-19 related restrictions in early March.
- Amortization of intangible assets increased by $1.1 million, which related primarily to the set-up of intangible assets for the Ascio brand, customer relationships, and technology, totalling $15.1 million, and Cedar customer relationships and network rights totalling $5.6 million.
- And lastly, there was a $0.8 million net increase in expenses related to foreign exchange impacts. Specifically, we had a loss of $400K in Q1 2020 related to mark-to-market remeasurements for our forward currency contracts that do not qualify for hedge accounting, compared to a gain of $0.1 million in Q1 of last year, resulting in a year-over-year expense increase of just over $0.5 million. In addition, we experienced a neutral impact on the revaluation of foreign denominated monetary assets and liabilities this quarter compared to a gain of $0.3M in the first quarter of 2019, which had the impact of increasing our expenses $0.3 million on a year-over-year basis.

As a percentage of revenue, total operating expenses increased to 24% from 22%.

Net income for the first quarter of 2020 increased 1% to just over $2.8 million, or $0.27 per share, from just under $2.8 million, or $0.26 per share.

Adjusted EBITDA increased 34% to $12.7 million from $9.4 million for Q1 last year due to the first full quarterly contributions from the Ascio and Cedar acquisitions noted previously, as well as organic growth across our three lines of business.

Turning to our balance sheet and cash flows, cash and cash equivalents at the end of the first quarter of 2020 was $12.4 million compared with $20.4 million at the end of the fourth quarter of 2019 and $11.0 million at the end of the first quarter of 2019.

During the quarter, we generated $14.1 million in cash from operations compared with $9 million in Q1 last year. Cash from operations was offset by our investment of an additional $9.9 million in property and equipment, primarily related to the Ting Internet build out, the net cash payment of $8.8 million for the acquisition of Cedar, and $3.1 million for the repurchase of shares under our open market buyback program. During the quarter we purchased just under 67,000 shares at an average price of $46.69.

Deferred revenue at the end of the first quarter was $153 million, up from $149 million at the end of the fourth quarter of last year, but down from $159 million at the end of the first quarter of last year.

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

Closing Remarks [Elliot Noss, President and CEO]

Thanks Dave.

In February we renewed our open market buyback program, under which we can purchase up to $40 million of our stock until February of 2021. As Dave just mentioned in his remarks, we repurchased roughly 67,000 shares at an average of $46.69 a share, with a total spend of $3.1 million. We were quite pleased to be able to acquire shares at these levels.

Last quarter we provided guidance for 2020 of $50 million in EBITDA. The first quarter was comfortably on plan, but this year contains both more challenges, and more opportunities than we have ever seen. Accordingly, we will leave guidance where it is at this time, but will do what is best for the business as this all unfolds.

We expect this call to be the first of a number of quarters where we will be sharing results and changes in this current environment. Accordingly, I will try and share the broad principles that are informing our thinking through the pandemic.

The greatest certainty in the current situation is uncertainty. As a leader, I feel my greatest strategic responsibility right now is to distinguish between what I can know and what I cannot, and to act accordingly. And there is so much that I, and we, cannot know.

We cannot know when businesses and everyday life will return to normal. We cannot know what that new normal will look like. We do know that it will be very different from the world before the pandemic.

With all of this we take a very conservative view. We are planning for the current circumstances, with minor variability, to persist for the foreseeable future. And we are planning accordingly. We are rethinking our installation practices, our marketing practices, our human resources practices, our product offerings and more; and in almost every case, we believe the changes we are making and will continue to make, are more or less permanent.

We believe this because we believe that the changes wrought by this pandemic are not new. Rather they are significant accelerations of previously existing trends.

So what are the changes that we believe we have some certainty about?

It seems obvious that work from home, a trend we were fortunate to be in front of, will greatly accelerate. This has implications not only for the amount of office space a company needs, but also the shape of that space. It also opens up the world as a source of talent. Thus a significant rethink in the way we approach technical talent, and in fact a rethink of all of our people practices.

There will be less business travel, and in fact travel of all types. I have travelled 10-12 weeks a year consistently for the last twenty years. I will never travel that much in a year again. The whole retail, travel and hospitality industries are reconfiguring before our eyes and will never be the same.

We see equally significant and permanent changes in automotive and fashion. And combining those with retail, travel and hospitality, and the whole world of marketing as we knew it changes.

Now layer all of that on top of a massive acceleration of the trend towards cord cutting and away from linear video. And combine the uncertainty of the future of major sports leagues.

In this context, we are wide open to rethinking our marketing practices and the way we deliver services.

Tucows has been around a long time. We have been through two other significant crises; the dotcom bust, and the 2008 financial crisis. But they were different. They were both economic crises. This time we are dealing with a health crisis that has a significant economic valence. Because of this the societal remedies need to be focused on health, safety and security. But the economic impacts will be deeper and broader than either of the previous two crises.

Both of those previous circumstances shaped Tucows and our company culture. I have joked with many of you that living through the dotcom bust has made us behave like a child of the Depression. It has led to our focus on generating cash, on living within our means, on our general fiscal conservatism. Those experiences serve us well here.

But in both those crises, the company was in a different place. In 2000, and in 2008, we were working and struggling to survive. Not now. Now, all three of our businesses have the wind at their back through the pandemic. This makes applying the learning, and the nature of the challenges, different.

There is no question that in these times, with this level of uncertainty, a baseline of conservatism is important. And with us, it is also deeply ingrained. But this time it is a bit different. This time we have a much more powerful baseline business; in fact three of them. We have a deeper bench. We have much of our competition -- particularly those with much broader business portfolios -- on their heels.

If they are on their heels, perhaps we can be on our toes.

And any moves that are towards growth will be informed by our view that we are in a significant reshaping of our economy. And we believe an important element of that reshaping is recognizing that we now live in a growth- and yield-starved world.

Like many of the above long-term trends, the pandemic has greatly accelerated this one. Reliability and predictability of earnings become relatively more important. The significant amount of capital available, and shifts in demographics and consumption patterns were making returns harder to come by. This significantly informs our capital allocation and finance practices.

In conclusion, I hope that this provides you with the broad principles that we are basing our thinking on. We see changes across the business. People, technology, product, marketing, finance. We hope to be able to balance conservatism with opportunism.

The world was awash with capital before the pandemic. It still is. Right now, finding return with low beta is like finding a four leaf clover. Right now, we feel a bit like leprechauns.

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 by May 13th, and look for our recorded Q&A audio response and transcript to be posted to the Tucows website on Wednesday, May 20th at approximately 4 p.m. eastern time. Thank you.
