Tucows Q3 2020 Management Remarks Transcript

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

Welcome to Tucows' third quarter 2020 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 remarks, shareholders, analysts and prospective investors are invited to submit their questions to Tucows' management via email at ir@tucows.com, until Tuesday, November 10. Management will address your questions directly, or in a recorded audio response and transcript that will be posted to the Tucows website on Tuesday, November 17 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 seven 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 Presentation. Please note that the KPI Summary has been modified to reflect our transition from a Mobile Virtual Network Operator to a Mobile Services Enabler. This means the mobile metrics that are no longer applicable to our business have been removed.

Now for management's prepared remarks:

On Thursday, November 5, Tucows issued a news release reporting its financial results for the third quarter ending September 30, 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]

Q3 Results Summary

Thanks Monica. Q3 2020 was another strong quarter of performance. I do want to highlight at the outset that our revenue and gross margin figures for the third quarter reflect our transition to a Mobile Services Enabler model from an MVNO model, and the sale of the vast majority of the Ting Mobile customer base to DISH Networks, a third of the way through the quarter.

Dave will discuss in more detail, but here is a cheat sheet. The complicating factor is the compensation we got for the customer base. Money received for the earn-out on the sold customers is being recognized under "Other Income," which sits below "Operating Income," as a gain on the sale of the Ting Mobile assets. This income stream will remain in place for well over five years.

When we considered this transaction we looked at improving the cash contribution to the overall business and we considered all amounts received as part of the analysis. We knew it would complicate our reporting, and make it more difficult to follow, but we give our investors credit for being able to follow, and we maximize for cash generated.

The amount in other income will be relatively close to what the sold customers would have generated on a contribution basis and will decline over time, roughly with churn. As a result, as we transition to the MSE business, our reported revenue and gross margin results will be negatively impacted with all of that revenue and much of the expenses associated with it now subsumed in Other Income.

We are however, including these earnings in our Adjusted EBITDA results and as such Adjusted EBITDA may provide a better year-over-year view on operating results.

For revenue and gross margin, the best way to view our performance for Q3 is by confining those to the Domains and Ting Internet businesses -- that is, absent the impact of Mobile. Revenue from our Domains and Ting Internet operations for Q3 was $65.5 million, a decrease of 1% from $66.4 million for the same period last year. A strong increase from Ting Internet was more than offset by a decline in Domains, however, I will remind you that last year's Domains revenue included a $1.9 million bulk sale from our Portfolio, as we exited that business. Excluding that bulk Portfolio sale, revenue for Domains and Ting Internet was up 2% year over year.

Gross margin for the Domains and Ting Internet businesses for Q3 was essentially unchanged year on year at $21.8 million. However, excluding the contribution of the bulk Portfolio sale, year over year, gross margin for Domains and Ting Internet was up 10%.

Although net income incorporates the net impacts of the transition of the Mobile business, the year-over-year comparable was impacted by three factors that I want to highlight. I already mentioned the large Portfolio sale in Q3 of last year -- that contributed approximately $1.5 million after tax. In addition, Q3 2020 net income was impacted by a higher effective tax rate in this year's quarter, which Dave will provide additional colour on in a few minutes. And we incurred a one-time, non-cash write-down, on the sale of Ting Mobile assets of $3.5 million, which is

included under "Other Income". Excluding the write-down of the Ting Mobile assets, net income was $3.4 million, or $0.33 per share, compared with $4.2 million, or $0.40 per share for Q3 last year, both down 19%, respectively.

Adjusted EBITDA for Q3 was $13.4 million compared with $14.8 million.

And finally, cash flow from operations was $11.4 million, up slightly from $11.2 million in Q3 last year, once again underscoring the ability of the Domains and Mobile Services businesses to consistently generate cash to invest in the outsized growth opportunity inherent in Ting Internet.

Domains

Now looking at each of our individual businesses, the Domains business delivered another solid quarter, with consistency and profitability of this business again benefiting from the acceleration of the digitization of the economy in response to the pandemic. This acceleration is decelerating, (for fans of a second order derivative). Adjusting for the $1.9 million bulk Portfolio sale in Q3 of last year, gross margin dollars for the Domains business increased 5% year on year, on a 1% decrease in revenue, as our focus on driving gross margin within this business continues to yield the intended results. Including that large Portfolio sale, gross margin decreased 5%, on a 4% decrease in revenue.

Wholesale saw another quarter of year-over-year growth in gross margin at 8%, with the Domain Services component increasing 17%, driven largely by a 5% increase in total registrations to 4.1 million, from 3.9 million. It was another especially healthy quarter for new registrations, which were up 30%. We expect growth to trend lower again in the fourth quarter as new transaction activity continues to decelerate, but still provide year-over-year increases not seen in the modern domain name era.

Our Wholesale renewal rate ticked up slightly in Q3 to 79%, once again solidly above the industry average, and once again underscoring the quality of both our resellers and the high attachment rate of their domains to real businesses.

In the Value Added Services component of Wholesale Domains, gross margin dollars declined 10% year over year, primarily from some one times events and natural fluctuations in the expiry stream revenue.

Our Retail Domains channel also continued to benefit from the higher transaction activity resulting from the pandemic. Total registrations for Q3 were up 6% year over year, to 387,000, with new registrations up 20%. Gross margin for the Retail Channel however, was essentially flat compared to Q3 of last year, as a result of the delay of the positive impact on gross margin of the higher transaction volumes, due to deferred revenue accounting. And the higher-priced Enom related names that have naturally been declining, as I have discussed previously -- those now only represent a little more than 10% of the Retail Channel gross margin.

The Retail channel renewal rate, like that for Wholesale, also remained solidly above the industry average, consistent with Q2 at 82%.

In my Q2 remarks in August, I discussed the benefits of the new domains infrastructure across all three of our businesses, and how we have teased out functional elements that were common across all three platforms, and in the process developed transferable capabilities and institutional knowledge. At this point in the year, we are deep into budget planning for 2021. And, as we are doing the work to shift the platform from a retail to an MSE service, we will take advantage of some of the key structural and architectural work that we did on the Domains platform. In fact, we have taken a core team who worked on what I would call the "nervous system" of the new Domains platform and shifted them over to the DISH initiative in order to leverage that very important work, and where we believe it will have the greatest near-term return on investment.

Mobile

On Ting Mobile, there is not a lot of news to report just yet. I will mostly continue to frame the business as I believe you should think about it and track it over the coming months, quarters, and years.

The Mobile business will be defined by three key line items – the earn-out on the legacy subscriber base sold to DISH; the platform fees on the Mobile Services Enabler or MSE platform; and the revenue and costs on professional services, including transitional or TSA services. For now, you will also see a line called Retail, which represents the small amount of Verizon subscribers that are still entirely ours.

The legacy base that generates the earn out continues to churn at historical rates, still quite low since COVID. That will get more interesting when Ting Mobile introduces new, DISH-enabled pricing, which we have hinted at quite broadly and should see shortly. We expect thousands of legacy customers to take advantage of that pricing. That should lower our churn rate. As for gross margin per subscriber, it will really depend on how the new pricing changes consumption. We have street tested this and we feel it will land within a very comfortable range.

Once we settle into that new subscriber churn rate and monthly gross margin per subscriber on the legacy base, I expect the earn out to be quite predictable as it declines steadily over time.

The small contribution you will see on the TSA for the first number of quarters, again, reflects our people that DISH is essentially contracting to continue to operate the retail business. To me, this line resembles our old mobile device sales in a couple of ways. First, revenue will be followed closely by expenses with a rather narrow margin that we retain. Said differently, this TSA revenue can potentially be a bit distracting and can look more exciting than it is. Second, it doesn't correlate to the real health of the strategic mobile business, which will be driven by the MSE platform revenue in the long term.

And finally, the MSE fees. Those fees will grow a bit in the coming quarters as we add new subscribers on Ting Mobile. Then they will grow appreciably once we are on the other side of the Boost migration sometime in 2021. And we hope for material upside in 2022 and beyond, as Dish grows its mobile business and we potentially bring additional providers onto the platform.

Back in the present, we have started our work in earnest to support DISH and migrate Boost.

After our first quarter operating in the new paradigm, we are comfortable that Mobile's contribution to the overall business will increase as expected. We expect contribution growth from this segment post-Boost migration, a welcome change from the flat to down we have had the past couple of years.

For the next while, the mobile section of the quarterly call will get smaller. We are a business with one customer. You can easily track our customer's progress on their investor call. We will keep you apprised of what you need to know to follow the business. That will just be much simpler for a period.

Ting Internet

Moving on to Ting Internet, the third quarter continues to illustrate the results of our efforts to scale the business, with new highs in subscriber growth and capex spend in particular.

That being said, we note that internally, we view these as modest gains compared with what we continue to learn in building and operating more efficiently; the foundational work we're actively undertaking to accelerate growth; and the opportunities in front of us. We are even more bullish on fiber Internet access, and we were quite bullish before. The pandemic has emphasized the importance of high-capacity, symmetrical bandwidth. We continue to feel that by far, the best is yet to come in this business.

Our investment in capex continues to trend in an upward direction, with $10.7 million spent in Q3, representing an increase of 25% from Q3 of last year. We passed 3,700 new addresses, and 2,600 of those became serviceable, bringing us to a total of 50,500 serviceable addresses, an increase of 48% from Q3 of last year. We had a bump in serviceable addresses with the lighting of central office facilities in Fuquay-Varina, North Carolina, in Q2, and Centennial, Colorado, in Q3. We expect to light more facilities in North Carolina and Colorado in Q4, which will continue to grow our serviceable addresses and feed our subscriber funnel.

In Q3, we saw our biggest quarterly net subscriber increase of 1,200 subscribers, bringing us to a total of 13,700 subscribers. The pent-up demand for Ting fiber remains very strong. The pandemic-induced increase in demand for fiber, combined with reduced installations during the first month of COVID created a large backlog of orders for us. We've been grinding through the backlog and increasing our installation capacity, but despite that, the backlog remains this quarter, due to ever-increasing demand and orders. We view this as a good problem to have, and are working on adding resources and streamlining processes to get through it.

A key focus for our fiber business currently is increasing our build velocity. This is partly because of where we are in the trajectory of the growth of the Ting fiber operation, and where we've laid the foundations -- with people, with platforms, and with processes, to support scale. But there is a pressing urgency now, as we're seeing the time frame for the generational transition from coax to fiber compressed as a result of the pandemic-induced, nation-wide clamour for fiber-to-the-premises service. As we look to our 2021 planning, we're hoping to significantly increase our capex spend over 2020. Investors should expect our investment in fiber, our announcements of new markets, and evolution of our operations and products, to reflect our focus in ramping up this business. You'll see us in new markets that give us more year-round build velocity to offset our seasonal builds in Colorado and Idaho. And new ways to build and install faster.

One new development is microtrenching. It has been deployed widely in Europe, and has been used in North America for about a decade, and is at a point where we can find experts with solid track records who are utilizing best practices here. This is a new deployment method for Ting that adds to our competencies in traditional underground and aerial fiber construction. Microtrenching specifically gives us a new option to deploy that is less expensive than underground drilling and boring, and is materially faster. It also enables us to navigate cities, and areas within cities, with compromised access to the public right-of-way, which is an issue we encounter in older communities. Look for us to be utilizing microtrenching more broadly in 2021.

Another goal for 2021 is to deliver a comprehensive product lineup to business, institutional, and residential customers. We've been in this business for five years now, and expanding our offerings is part of our natural growth. This will create additional revenue streams, but is more focused on increasing take rate by removing holes. We are already seeing increasing demand for our newly offered devices such as TV streaming boxes and Mesh WiFi extenders for our residential customers.

Finally, our private infrastructure partner SiFi Networks, deploying in Fullerton, California, began to light its network at the tail end of Q2, with Ting's first customers coming online there in early July. Our infrastructure partner Netly Fiber, deploying in Solana Beach, California, completed its first phase of passed addresses at the end of Q2, and we lit our first customers in August. We're now working through installation of pre-orders in serviceable areas in both markets.

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.

Given that Elliot already summarized the mechanics of the financials of the Mobile Services business at the outset, I won't review those here again but will speak to them specifically within

the context of the results. You can also refer to the note at the beginning of our news release for an explanation of those and the impacts for our Q3 results.

Total net revenue for the third quarter of 2020 was $74.3 million, a 16% decrease from $88.1 million for the third quarter of last year. As Elliot discussed, the majority of the decrease was the result of the sale of the Ting Mobile customer relationships on August 1, but was also due to the large bulk domains sale in Q3 last year from our Portfolio business, which we have since exited. Those decreases were partially offset by continued strong growth in Ting Internet revenue, largely the result of the Cedar Acquisition in January of this year, but also the result of the continued growth in the Ting Internet services customer base.

Cost of revenues before network costs decreased 13% to $48.3 million, from $55.8 million for Q3 of last year, with the decline primarily due to the lower revenue. As a percentage of revenue, cost of revenues before network costs rose slightly to 65%, as the improved mix in the Domains business was offset by the shift in mobile revenues, including the addition of low margin transition services to DISH.

Gross margin before network costs for the third quarter decreased 20% to $26.0 million, from $32.4 million, with the decrease primarily related to the sale of Ting mobile assets and to a lesser extent the outsized portfolio sale in Q3 2019. Note, the margin generated by the mobile customers sold to DISH is now incorporated in the earn-out recorded in Other Income. As a percentage of revenue, gross margin decreased to 35%, from 37% in Q3 2019.

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

Starting with Domain Services, gross margin for the third quarter decreased 5% to $18.9 million, from $19.9 million in Q3 last year. However, excluding the large bulk domains sale I referenced earlier, gross margin increased 5%. As a percentage of revenue, gross margin for Domain Services was unchanged from Q3 of last year at 31%. But, when excluding last year's bulk sale, gross margin was up 2% year on year.

Within the Domain Services business, gross margin for the Wholesale Channel increased 8% to $14.4 million, from $13.3 million for the same quarter last year, the result of year-over-year growth in the number of Domains under management, as well as the success of our continued focus on managing the business for gross margin -- in particular, our focus on high quality customers.

As a percentage of revenue, gross margin for Wholesale increased to 28%, from 25%.

Gross margin for Retail Domain Services was unchanged from Q3 of last year at $4.4 million, and was relatively flat at 50% as a percentage of revenue.

Turning now to Network Access, gross margin for the third quarter decreased 43% to $7.1 million, from $12.5 million in Q3 last year. Again, the vast majority of that decrease is the result of the

absence of revenue and margin for the last two months of the quarter from the Ting Mobile customers we sold to DISH.

Mobile Services gross margin decreased by 61% year over year to $4.1 million, from $10.6 million as a result of the transition in that business from Retail Services for the first month of the quarter, to our MSE model for the last two months of the quarter. The comparative period of last year was, of course, entirely Retail Services.

I will note, however, we generated $1.1 million in "Other Income"; specifically, the Gain on the Sale of Ting Customer Assets on the face of the income statement, which represents the earn out on that customer base net of a $3.5 million non-cash write-down of certain intangible assets from prior MVNO customer relationship acquisitions.

Looking at the Fiber Internet Services business, gross margin increased 52% to $3 million, from $2 million in Q3 last year, driven by the incremental contribution of Cedar Networks, acquired at the start of this year, as well as continued growth in the Ting Internet subscriber base.

As a percentage of revenue, gross margin for Network Access increased to 53%, from 51% in Q3 of last year, with Mobile Services dipping to 47%, from 49%, and Fiber Internet Services declining to 64%, from 68%. YTD 2020, gross margin as % of revenue is 62% for the Fiber business.

Turning now to costs, network expenses for Q3 2020 increased 26% to $6.0 million, from $4.8 million in the same period a year ago, with the increase being primarily due to higher amortization resulting from the continued buildout of the Fiber Services network, as well as the incremental impact from the Cedar acquisition.

Total operating expenses for the third quarter of 2020 decreased 2% to $18.6 million, from $19 million for the third quarter last year. The decrease is reflective of the reduction in certain costs related to the Ting Mobile assets sold to DISH, such as customer service and fulfillment. Those costs are now reflected in the net earn-out numbers within Other Income. Normalized for this impact, expenses increased $1.4 million due to the following:

- Excluding the impact from the acquisition of Cedar on January 1st of this year, people costs increased by $1.8 million, primarily from an increased workforce to support business expansion, including the Ting Internet expansion and the Ting MSE platform build, as well as $0.4 million from higher anticipated performance bonus payments year to date versus last year due to improved business performance. These were offset by a $0.2 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;
- Cedar related expenses added $0.6 million to the quarter, primarily workforce related;
- Marketing costs decreased by $0.2 million, while costs related to travel and other discretionary expenses decreased by $0.4 million;

- Amortization of intangible assets decreased by $0.2 million, due to the write-down of the Ting Mobile assets offset by the set-up this year of intangible assets for the Cedar customer relationships and network rights totalling $5.6 million;
- Finally, last year we also had a loss on disposition of property & equipment for $0.1 million with no corresponding loss in Q3 2020.

As a percentage of revenue, total operating expenses increased to 25%, from 22%, with the increase being mainly due to the lower revenue in Q3 this year resulting from the sale of the Ting Mobile customer relationships to DISH.

Net income for the third quarter of 2020 was $0.7 million, or $0.07 per share, compared with $4.2 million, or $0.40 per share in the third quarter of last year. Net income was impacted by the non-cash write-down of certain assets related to the sale of the Ting Mobile customer relationships to DISH. Excluding the after-tax impact of the write-down, net income would have been $3.4 million, or $0.33 per share, down 19% year over year. The primary drivers of the decline -- excluding the write down -- were the outsized portfolio bulk domain name sale in the third quarter of 2019, and a higher estimated annual effective tax rate driven by the geographic mix of our income.

Adjusted EBITDA for the third quarter decreased 11% to $13.3 million, from $14.8 million for Q3 last year. Excluding the impact of the outsized bulk domain name sale last year, Adjusted EBITDA grew 3%.

Turning to our balance sheet and cash flows, cash and cash equivalents at the end of the third quarter of 2020 was $10.2 million, compared with $8.9 million at the end of the second quarter of this year, and $12.0 million at the end of the third quarter of last year.

During the third quarter, we generated $11.4 million in cash from operations compared with $11.2 million in Q3 last year. Cash from operations was substantially offset by our investment of an additional $10.6 million in property and equipment, primarily related to the Ting Internet build out.

We did not repurchase any stock during the quarter.

Deferred revenue at the end of the third quarter was $154 million, down slightly from $155 million at the end of the second quarter of this year and flat compared to the end of the third 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 the value investment community investors like the concept of an owners manual, and on some level that is the way I view these ongoing transcripts.

This quarter there are a couple of elements that feel like important additions to the manual. The first, the way to track our mobile business going forward, made up a fair bit of my opening comments and I expect, as time passes, will take up some more.

The other is what we expect from Ting Fiber in the coming years.

I have previously mentioned that we now see the bulk of the transition from coax to fiber in the US taking place over the next 5-6 years, not the 10-12 years we previously expected. I have also noted a number of times in recent remarks that smart money was pouring into this asset class, around the world -- but in the US in particular. There are implications that land in the numbers that I want to help you all understand.

The first implication of the above is that we want to accelerate an already aggressive plan to lay as much fiber as we can. We have noted repeatedly the influx of capital to the space. In a yield-starved world, mature assets in a fantastic infrastructure asset class like fiber-to-the-home are trading at very lofty multiples. Fiber is a utility that looks like a business. Yet currently, if one has the skills and wherewithal to be able to build and operate these assets, one can build EBITDA at 4-5 times, which puts a huge premium on building as much as possible. We will continue to attract and invest in world class management talent in this regard.

This creates the second implication. The faster we build, particularly in new footprints, the greater the drag on cash EBITDA. At the same time we are seeing the expected, strong growth in cash generation in the markets we are already in. On some level we are doing two things inside the same business segment. Building assets that will yield EBITDA at great returns, and operating assets that are providing amazingly consistent returns and trade at high multiples. Our challenge here becomes helping you, the investor, understand the interrelationship between those two. This means enhancing our Fiber metrics, including looking at ways to provide more detailed analysis on a city level.

The third factor that I want you all to be aware of, is that the fact that we are public is unique in the space in the US. When we look at the other management teams that are leaders in this transition from coax to fiber, they are all backed by private equity or infrastructure funds. They openly talk about the advantages of "long-term capital," and not having to obsess over meeting quarterly numbers. We would like to meet this head on. We believe that our investors are, overwhelmingly, long term in their thinking. I know I am. And I know we are. We also believe that we will have no problem with access to capital as we continue this journey. The combination of a yield-starved world, the abundance of capital, and the attractiveness of the space provides more than enough opportunity for capital without having to change our corporate structure. But we do want our investors to be aware of our uniqueness in this regard.

The fourth factor as we grow is understanding the difference between growth in the machine and growth in more direct operating expenses at a city level. We will have to provide investors with more tools and more information in order to aid in this understanding. As a reminder, the fiber machine is the centralized cost necessary to build and launch fiber assets. What we expect here is a declining ratio of these centralized costs relative to capex spent in a period.

In closing, I want to reiterate that there is consensus among those participating in the coax to fiber transition -- infrastructure funds, private equity firms, bankers, consultants, and suppliers -- that the scarce resource is not capital and is not opportunity, it is management. And we continue to believe that we have the best management team attacking this opportunity. We say that with respect to a lot of existing operators but we think two things set us apart. First, a number of us have been involved in the ISP space since the early days of dialup and that experience is invaluable. Experience building fiber is important, but only for the first couple years of a build. Operating those assets is important for the next hundred years. Second, we believe we are the only operator who builds and maintains their own software stack. This provides us with significant advantages that manifest primarily in speed and customer experience -- but of course, also have an operating cost advantage.

We are aware as we enter this next phase that we will be asking a little more of our investors, and we will need to provide more tools in this regard. We are also extremely confident that our investors are up for the challenge and we expect to reward them handsomely for their support.

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 November 10, and look for our recorded Q&A audio response and transcript to this call to be posted to the Tucows website on Tuesday, November 17 at approximately 4 p.m. eastern time. Thank you.