tucows

Q2 2019 Q&A Transcript

Introduction

Welcome to Tucows' Q2 2019 post-quarter question and answer dialogue with Elliot Noss, President and Chief Executive Officer. Thank you once again to all those who submitted questions over the period subsequent to the call. For your convenience, this audio file is also available as a written document in the investors section of our website, along with Q2 2019 financial results.

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 Form 10-Q and Form 10-K. The company urges you to read its securities filings for a full description of the risk factors applicable for its business.

Our current approach is pre-recorded management remarks followed by solicitation of follow-up questions. We are grouping similar questions into categories that we feel are addressing common queries. If your questions reach a certain threshold or volume we may ask you to schedule a call instead, to ensure we can address the full body of your questions. And if you feel that the recorded answers and/or any direct email you may receive, do not address the meat of your questions, please let us know.

Go ahead Mr. Noss.

Remarks [Elliot Noss, CEO]

Thank you for listening in on our Q2 2019 Q&A.

DOMAINS

First, I'll address a question we received on our Domains business asking about the old technology barriers I referred to on the Q2 call.

Both the OpenSRS and eNom platforms were nearly twenty years old. As was the case at the time, they were each built as monolithic platforms, and each was built using very different technologies and very different architectures. We knew that when we bought eNom that we were inheriting a pile of technical debt, much like the pile we already had.

Technical debt makes it more complicated (and therefore expensive), to operate a platform. It makes it more prone to reduced performance or even outages, and it makes data generation, analysis, and reporting, much more difficult. What companies can do with data today is far beyond anything contemplated at the dawn of the 21st century.

One of the advantages of buying eNom is we had parallel technical debt and thus we were amortizing dealing with it over double the size of the business. We viewed this as turning a negative into a positive.

The only thing harder than operating under a load of technical debt is fixing it! We are now finally starting to see the benefits coming out the other end of the factory. It is important to note that this is not behind our expectations, nor is it at odds with the additional financial synergies we talked about at the time of the deal.

These are additional benefits. I would primarily describe them as easier to operate, more reliability, more extensible -- thus easier to evolve as technology improves, and finally, easier to introduce additional features and services. And I appreciate this is a nuanced point, and I am happy to go deeper with anyone interested.

TING INTERNET / TV

We had a question about launch timing for Ting TV. Ting TV is now in market on a selective basis. For months, we have been gathering a long list of leads who are interested in our TV service. In Holly Springs, the first town we are trialling it in, we have been beta testing the product. We are now pulling prospects off that list and offering them TV discreetly. These are prospects that otherwise would not have signed up for Ting Internet. These are new, paying customers. We are not launching TV publicly on the website, as we are carefully monitoring and controlling the experience, from activation to billing to service to customer support. We will next launch this way in Charlottesville, then in the other towns. Once we are completely confident in the experience, we will open it up on the website. We are in no rush. TV is an experience that people are very used to, and it is the one area where coax cable has an advantage over fiber unless one is very deliberate in the service design.

Based on the prospects that have expressed interest and responded to our discreet invitations, we are already encouraged that TV will have the desired impact on our Internet adoption.

TAXES

We were again asked about why the tax rate increased from both Q1 to Q2 and why it is increasing over time.

I wanted to refer back to the [Q&A transcript from the 4th quarter of 2018], and make a few additional comments. We are including the relevant language in an appendix at the end of the written transcript. If you want to understand this issue, please read it.

First, 2019 is likely to be the high water mark for our effective tax rate. The work we have been doing on our domains platform mentioned above starts to impact this year, and as it does we are able to more effectively structure our affairs.

Second, our cash tax is not increasing materially. As the accounting losses in the US increase with our fiber investments, the effective rate goes up, not the cash paid. Canadian gains combine with US losses in the denominator, but the numerator -- tax on profits in the domain name business -- stay the same. Thus, the effective rate goes up.

Finally, we can expect our cash tax situation to improve and remain in a positive trend for some time to come, as we restructure our affairs and increase our capex spend. This will positively impact our conversion from EBITDA to free cash flow for some time to come.

Again, thank you for listening in on our Q2 2019 Q&A, and a reminder that if you feel that the recorded answers and/or any direct email you may receive do not address your questions, please follow up with us at ir@tucows.com.

APPENDIX
A few of you asked for more detail on our 2018 taxes. There are a number of considerations impacting our taxes, so bear with me on the complexities.

Our effective tax rate for 2018 is approximately 34%; higher than the 21% US Federal tax rate and the 26% Canadian tax rate. Setting aside regular reconciling items such as the impact of US state taxes, and the timing of exercise of stock-option deductions, there are two main drivers for the variance.

First, our legacy domains business--meaning our domains business outside of Enom--is domiciled in Canada, but considered a US taxpayer. The earnings from this legacy business are first taxed in Canada at 26%, which generates a foreign tax credit against our US taxes on that same income. The impact of the Canadian taxes, which are 5% higher than US corporate taxes, is that a portion of the credit cannot be utilized on the legacy domains earnings stream.

Further, due to the new bonus depreciation rules enacted in late 2017 under the US Tax Cuts and Jobs Act, which allow the 100% expense treatment for certain eligible capital expenditures for tax purposes, our taxable income sourced in the US is negative, thus we cannot take the full benefit of the Canadian credits. Although available to be carried forward as tax credits, we don't believe that we will be able to utilize those credits based on the current tax rate differences, and as such, have taken a valuation allowance against those credits. The impact of the valuation allowance increases the effective tax expense. We had a similar phenomenon for the year ended December 31, 2017. A full effective tax rate reconciliation will be provided as part of our upcoming 10-K filing in March.

As the balance between domains and telecom net income changes, and as we are able to more effectively structure our operations, the effective rate will improve. We are providing no additional guidance in this regard as we are also trying to grow our capex, and thus our deductions, as fast as possible.