



Q1 2019 Management Remarks Transcript

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

Welcome to Tucows' first quarter 2019 investor call. Management has pre-recorded its prepared remarks regarding the quarter and outlook for the Company. A transcript of these remarks is also available on the Company's web site. In lieu of a live question and answer period following the prepared remarks, shareholders and analysts are invited to submit their questions to Tucows' management via email at ir@tucows.com. Management will address your questions directly, or in a recorded audio response and transcript that will be posted to the Tucows website on Tuesday, May 21st at approximately 4 p.m. eastern time.

We would also like to remind you of the Tucows Quarterly KPI Summary that we began publishing on our website last quarter, which provides key metrics for all of our businesses by quarter since 2017. The updated version is available now in the Investors section.

Now, on to management's prepared remarks.

On Wednesday, May 8th, Tucows issued a news release reporting its financial results for the first quarter ended March 31st, 2019. That news release, and the Company's financial statements, are available on the company's website at tucows.com, under the Investors page.

Please note that the matters the company will be discussing include forward-looking statements and, as such, are subject to risks and uncertainties that could cause the 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-K and Form 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 CEO]

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

Now on to the quarter.

While it might not appear to be, the first quarter was in fact a solid start to 2019. Total revenue was \$79.0 million, compared to \$81.2 last year, excluding the acceleration of nearly \$15 million in revenue resulting from a bulk transfer. Gross margin dollars were essentially flat. Net income was \$2.8 million, compared with \$3.7 million in Q1 last year, and adjusted EBITDA was \$9.4 million compared to \$10.4 million, both impacted by some outsized costs that we will discuss in more detail.

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

Our **Domains** business saw another quarter of consistent performance.

The wholesale channel again benefitted from the price adjustments implemented in the first half of last year. While registrations during the quarter, adjusted for the bulk transfer of names, were down 3% year-over-year, at approximately 4.1 million, gross margin dollars for wholesale domain services were up 9%. The wholesale renewal rate continued its strong performance at 77%.

Gross margin dollars from value added services for Q1 were down 5%, primarily due to mediocre expiry stream results.

In total, the wholesale business grew gross margin as expected at 4%.

In our retail domains channel, we had total registrations in Q1 of approximately 420,000 versus 460,000 in the same period the prior year, with the decline coming primarily from the Enom brands. Gross margin dollars, however, were still up 6% year-over-year.

The renewal rate for the retail channel was also 77% in Q1. Renewal rates for both the wholesale and retail channels continue to track solidly above the industry average.

Late in the quarter, we further expanded our wholesale domains business with the acquisition of Denmark-based wholesale domain registrar, Ascio Technologies. Like Melbourne IT and Enom before it, we have known the folks there for nearly twenty years. Ascio is an excellent business with a deeply experienced team, and it presented a great opportunity for us to add more than 1.9 million domain names, as well as a base of 500 high-quality active resellers. This not only strengthens our European presence, but fits squarely within our existing customer profile -- ISPs, web hosting companies, and website builders serving quality businesses that place a premium on outstanding customer service.

We paid just over \$29 million for a business that generated approximately \$4 million of EBITDA annually, pre-acquisition, and that we expect will provide synergies over the next 12 to 24 months. The acquisition was immediately accretive.

Ascio is another great example of taking advantage of an opportunity to acquire, integrate, and benefit from our even greater scale of operations.

A reminder here that we are required to apply purchase price accounting rules to the assets and liabilities acquired, including fair valuation of the acquired deferred revenue balance, as you will remember was the case following the Enom transaction. Dave will provide some of the accounting details.

In our Portfolio business, the first quarter saw gross margin of about \$150,000, versus \$700,000 for the same period last year. This reflects the smaller size of the portfolio and some underperformance. As discussed a number of times, the domains portfolio is a non-strategic asset class which we have lessened our exposure to. We do expect to see some increased variability in the gross margin contribution from quarter to quarter -- and Q1 is a good example of this.

Now onto **Ting Mobile**.

Revenue for Q1 was down 4.9% versus a year ago, and down 7.6% sequentially. Gross margin was down 5.1% versus a year ago, and down 9.2% sequentially.

In Q1 we experienced non-product costs due to our current carrier relationships -- both penalties and other costs that were well in excess of what we have had in the past. That outsized impact was over \$1 million.

We have talked too much for my taste recently about our carrier relationships. We expect to have some longer term clarity shortly, and to discuss it in more detail on the next call. My only comment at this time is that I expect our carrier relationships to be more profitable and productive in the future than they have been for the last couple of years.

In addition, we saw a rare decrease in data usage per account in Q1. Data usage has started to pick up again in spring, as it usually does, with folks spending more time beyond WiFi.

We finished Q1 with about 160,000 accounts and 284,000 subscribers, a loss of about 2,600 accounts and relatively flat on subscribers outside of the loss of one large, low margin IoT customer. I note that this corresponds roughly to a similar gain in Q3 2018 that we called out at the time. Outside of that loss, the number of subscribers would have actually grown in the quarter with very strong added lines on existing accounts.

Churn for Q1 was 2.83%, essentially flat versus 2.86% Q1 a year ago, and improved versus 3.11% in the prior quarter.

That churn number is particularly impressive to us because it includes a few thousand customers we recently migrated from The People's Operator, or TPO. We expect any base acquired inorganically to churn at higher rates, but these customers are through their initial service credits and seem to be sticking around at a rate that is in line with our more mature base. Knowing that we can migrate, accommodate, and retain acquired bases as successfully as we have been able to, gives us more room to take advantage of these opportunities and as competition continues, we see more of them.

We are encouraged by this. We also believe there is room for improvement in both marketing and churn, and remain confident that we can continue to grow this business.

Finally, **Ting Internet**.

At the end of 2018, we had roughly 28,000 serviceable addresses in five markets, and 7,000 active customers. In Q1, we added about 4,000 serviceable addresses, including the first batch in Fuquay-Varina. And we added about 700 customers. That brought us to totals of about 32,000 serviceable addresses and 7,700 active customers. Our capex spend in Q1 was \$6.9 million; continuing to ramp up. I note that capex will be unusually uneven for the rest of the year with Q2 reflecting overlapping peak builds in both Centennial and Fuquay-Varina. We remind investors that the number provided last quarter was \$35 million in fiber capex for 2019.

We did feel the impact of winter in our mountain markets in Q1, slowing down both construction and customer installs. We are now delivering on that pent-up demand, and installs in particular are catching up in Q2. I note that in April, our installs equalled all of the installs from Q2 of last year. Necessity is indeed the mother of invention, and every challenge is an opportunity to learn and improve. By next winter we will be armed with techniques to better deal with installing customers impacted by snow and ice.

Q1 was a strong quarter for adding future serviceable addresses and customers to our pipeline. I mentioned last quarter the announcement of Wake Forest, North Carolina as our seventh Ting Town, which actually occurred in Q1. Wake Forest will add about 10,000 serviceable addresses at scale, and we expect to start lighting up customers by the end of the year. Soon after that announcement, we started lighting up our first customers in nearby Fuquay-Varina. We expect Fuquay-Varina to also deliver about 10,000 serviceable addresses at scale. Both of these Research Triangle towns benefit greatly from the brand awareness and operational footprint we've built in Holly Springs, and I am thrilled that our level of pre-orders, and the speed and quality of construction there have validated those advantages.

Just another word on Fuquay-Varina. We always hope that towns across the country will appreciate the far-reaching value of fiber to the premises: stimulating and attracting business; fostering community, education and healthcare; increasing home values; and overall desirability

of the community. We also hope our towns will be surprised and delighted by a service provider like Ting that is energetic, innovative and eager to please. The comments by the Mayor, Town Manager and first customer in Fuquay-Varina at our lighting ceremony captured these benefits beautifully, [video link here](#) and I encourage you to see more of what is happening on the ground in our towns through the posts and videos on our Ting blog and YouTube channel.

In early April, we announced that Fullerton, California -- about thirty miles off the coast, in Orange County -- would be our next Ting town. Ting will provide service in Fullerton through a partnership with SiFi networks, a private infrastructure company. SiFi will build, own and operate the network and we will provide service on that network as we do in Westminster, Maryland (although, in that case, on municipal fiber). This model allows us to focus on what is still undeniably our core competency -- provisioning, billing, and supporting customers. It also helps us scale our serviceable addresses, and customers, and recurring revenue more quickly. Of course we do not own the physical plant and we do not have complete control of the service delivery, from network planning to construction to operation. We do not need to choose between our two approaches. We will continue to pursue a range of models and track the experiences and results of each closely.

Fullerton includes just over 50,000 serviceable addresses at scale. Although importantly, there is a competitive service provider with access to the same network. We do not expect or need the same 20% adoption in one year and 50% in five that we project in markets where we are the exclusive fiber provider. If you want a simple benchmark with two providers, cut it in half. We hope to light up customers in Fullerton either very late this year or early next. It will not affect gross margin this year. We will give more specific guidance when and if that number becomes material.

A few other insights and highlights from around the footprint.

In all our towns, we now are participating in greenfield builds -- or new housing developments. These allow us to add serviceable addresses to existing footprints, at a lower cost. We like everything about new developments. Getting our conduit, fiber and vaults into open trenches at the very beginning of construction is simpler and cheaper than building in existing neighborhoods. We get a fair shot at residents moving into new homes, without the encumbrance of existing contracts and early termination fees with other providers. We also have found developers to be enthusiastic marketing partners since crazy fast fiber Internet adds appeal to their properties, and the Ting brand has developed a stellar reputation in its existing footprints. Some of our markets--the Raleigh area and Charlottesville in particular--are seeing strong pipelines of new housing developments, which will drive organic serviceable address growth in these markets for years to come. As these opportunities materialize, greenfield

additions will show up as incremental increases in footprints' serviceable address counts over time.

We have completed our first full seasons of play as WiFi providers in the University of Virginia's Scott Stadium, and John Paul Jones Arena in Charlottesville. I would not credit Ting for the University of Virginia winning its first bowl game in over ten years, and its first ever NCAA men's basketball national championship in those first seasons. But it does seem like a remarkable coincidence. More importantly, those experiences have added greatly to our knowledge and skills on large scale fixed and wireless solutions, and will serve us well with campuses, public spaces, apartment buildings, corporate offices and other enterprise projects around the country.

Finally, Ting TV inches closer to public launch. We are testing extensively among friends and current customers. By later this year, we look forward to seeing how the addition of a television offering in select towns lifts our overall conversion to Ting.

We continue to feel confident about the core business as modeled. Adoption of 20% after one year and 50% after five. Customers deliver \$1,000 a year in margin. And our build costs are coming in between \$1,000 to \$1,400 per serviceable address, or \$2,500 to \$3,000 per customer at that projected 50% adoption.

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

Dave?

Financial Results [Dave Singh, CFO]

Thanks, Elliot.

Total revenue for the first quarter of 2019 was \$79 million. This compares to revenue for the same period last year of \$95.8 million and, as Elliot discussed, includes the acceleration of \$14.6 million due to the bulk transfer out of approximately 2.65 million very low margin domain names in the first quarter of last year. Excluding this amount, revenue for the first quarter of this year was about 3% lower than that of last year.

Cost of revenues before network costs decreased 25% to \$51.2 million from \$68.3 million for first quarter of last year, with the decrease due to the year-over-year decline in revenue. As a percentage of revenue, cost of revenues before network costs decreased 600 basis points to 65% from 71%.

Gross margin before network costs for Q1 increased marginally to \$27 million from \$26.8 million. As a percentage of revenue, gross margin before network costs expanded to 34% from 28% for

Q1 last year.

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

For Domain Services, gross margin for the first quarter was up slightly to \$15.6 million compared to the same period last year at \$15.4 million. As a percentage of revenue, gross margin for Domain Services for Q1 of this year was 28% compared with 21% for Q1 last year, with the increase primarily due to the atypically low reported gross margin in Q1 of last year resulting from the acceleration of the \$14.6 million of revenue, with essentially no gross margin, into that quarter, as I discussed earlier.

I want to just take a minute to note that our overall domains gross margin this year will be negatively impacted by our amortizing into revenue, deferred revenue that was recorded at fair value for the March 18th, 2019 Ascio Technologies, Inc. acquisition. The impact of this accounting will lower our overall adjusted EBITDA and gross margin by approximately \$3 million. A majority of this impact will be reflected in our 2019 results. Note, this is an accounting outcome similar to the Enom related deferred revenue fair value adjustment.

Looking at the individual components of Domain Services, gross margin for the Wholesale Channel increased 4% to \$11.1 million from \$10.7 million for Q1 last year. As a percentage of revenue, gross margin for Wholesale increased to 24% from 17%, mainly due to the acceleration of the low-margin revenue in Q1 of last year.

Gross margin for Retail Domain Services increased 6% to \$4.3 million from \$4 million in Q1 of last year and, as a percentage of revenue, expanded to 50% from 48%.

Gross margin for Portfolio Services decreased to \$0.2 million from \$0.7 million in Q1 last year. As a percentage of revenue, gross margin was 55% compared with 79%.

Moving now to Network Access, gross margin for the first quarter of this year was unchanged from the same period last year at \$11.4 million. A 5% decrease in gross margin from Ting Mobile was essentially offset by a 73% increase in gross margin from Other Services, driven primarily by growth in the Ting Internet subscriber base. As a percentage of revenue, gross margin for Network Access improved slightly to 49% from 48% in Q1 of 2018.

Turning now to costs, network expenses for the first quarter of 2019 increased 4% to \$4.4 million from \$4.2 million in Q1 last year. The increase is primarily due to increased amortization associated with the investment in the Ting Fiber network.

Total operating expenses for the first quarter of this year increased 4% to \$17.6 million from \$16.9 million for Q1 of last year. The increase is due primarily to the following:

- Workforce and third-party workforce-related expenses, increased by \$0.5 million partially the result of the growth in Internet subscribers and the Ting Internet footprint and as well, increased people costs from the acquisition of Ascio on March 18th;
- Marketing expenditures increased \$0.4 million related to higher spend on Ting Mobile, and;
- We had a \$0.4 million increase in other costs, including credit card fees as well as investments in tools and technology to support our growing employee base. This was partially offset by positive foreign currency impacts in the quarter, where we had a \$100,000 unrealized gain in Q1 2019 related to mark to market remeasurements for our currency forward contracts that do not qualify for hedge accounting compared a neutral impact last year. In addition, we experienced a foreign exchange gain on the revaluation of foreign denominated monetary assets and liabilities, which had the impact of decreasing our expenses \$0.5 million on a year over basis.

As a percentage of revenue, total operating expenses increased to 22% from 18%.

Net income for the first quarter of 2019 was \$2.8 million, or \$0.26 cents per share, compared with \$3.7 million, or \$0.35 per share, for the same period last year.

Adjusted EBITDA was \$9.4 million compared with \$10.4 million for Q1 last year. I will note that the impact of the fair value adjustment on deferred revenue related to the Ascio acquisition was about \$200,000 this quarter.

Turning to our balance sheet and cash flows, cash and cash equivalents at the end of the first quarter of 2019 was \$11 million compared with \$12.6 million at the end of the fourth quarter of 2018, and \$16.6 million at the end of the first quarter of last year. The decrease in cash from the end of Q4 of last year was primarily the result of our investment during Q1 of an additional \$10.4 million in property and equipment, primarily for the Ting Internet build out, which was substantially offset by the generation of \$9 million in cash flow from operations.

Deferred revenue at the end of the first quarter was \$159 million, up from \$144 million at the end of the fourth quarter of last year, and up from \$151 million at the end of the first quarter of last year. Both the year-over-year and sequential increases are due to acquisition of Ascio in March of this year.

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

Closing Remarks [Elliot Noss, CEO]

Thanks, Dave.

With the first quarter in the books, we are reiterating our 2019 cash EBITDA guidance of \$62 million. We do so from a similar position to last year. Three months into this year, we are about 18% of the way to our cash EBITDA guidance. At this same point in 2018, we were at about 22%.

Q1 was an interesting quarter in that all the negatives were anomalous short term impacts amidst a backdrop of positive long term trends.

In the short term category, we experienced our worst quarter of carrier penalties ever at Ting Mobile. By far. We dealt with a delay in the Ascio acquisition. And we experienced poor results in the domains secondary market, which for years now has been identified as a smaller tactical opportunity.

In the long term category, we saw continued progress in fiber passes and installs, particularly through March and April. We have more in the pipeline than ever before. We made material progress in sorting out our MVNO supply relationships, which we expect to share more about next quarter. We made a fantastic acquisition in the domains business that not only added a little more scale -- but also a strong group of new employees.

It is truly a quarter where it would be a lot easier to be private than public, but all of that makes me continually grateful for the nature of our investors.

This past week was the Berkshire Hathaway AGM. Value investors from all over the world descend on Omaha to listen to huge heapings of common sense. This tends to be the busiest week or two of the year for me for meeting with investors, as I assume the flight connections from Toronto to Omaha must be pretty good.

We met with potential new investors and extremely long-term holders. We met with traditional fund managers, family offices and money managers (as well as their clients in one case). We met with North Americans, Europeans and Asians. When speaking with that broad of a spectrum of investors about the Tucows business, a zeitgeist tends to emerge.

I have two strong takeaways from that experience. The first is a focus on people. How do we build and cultivate culture. How do we ensure that frontline employees, those who are closest to the customer and who most impact their experience on a day-to-day level, manage to make the right choices. What motivates us to do what we do?

And I realized that all of the answers were in the details. In the small choices and everyday interactions that sum up to a person's experience with a company. In finding the extraordinary in the ordinary.

The second takeaway was that our investors see the long term fiber opportunity as clearly as we do. They focus much of their dialogue on understanding and then checking on the progress of

that business unit. There is no amount of me reminding them about its size relative to the rest of the business, or about the time required to build massive scale that takes them away from the meta, from the most important big picture element of the discussion: The long term opportunity of the fiber business.

I come out of these meetings emboldened, humbled, appreciative and, most importantly, focused on us being the first, best Internet telecom company in the world. In building our organizational muscles to scale up faster, but not too fast. In recognizing that we can only do this well and right by continuing to improve, particularly in the areas where we are already best in the category. In finding the extraordinary in the ordinary.

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.

Thank you.