tucows Tucows Q2 2020 Management Remarks Transcript

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

Welcome to Tucows' second 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 Wednesday, August 12th. I will note that the Q&A from this call will be combined with the Q&A from the call from this past Monday, August 3rd on the DISH acquisition of Ting Mobile assets. Management will address your questions directly, or in a recorded audio response and transcript that will be posted to the Tucows website on Monday, August 17th 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, August 6th, Tucows issued a news release reporting its financial results for the second quarter ending June 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]

Q2 Results Summary

Thanks Monica. Q2 2020 was another strong quarter of performance, marked by a post-quarter change in a changing world.

Starting with the high level results for the quarter, total revenue for Q2 2020 was $82.1 million, a decline of 2% from the same period last year, with a strong increase in Ting Internet being offset by a decrease in Ting Mobile. Gross margin dollars before network expenses increased by 4%, with increases in both Domains and Ting Internet being partially offset by a decline in Ting Mobile.

Net income, which included two non-cash, non-recurring items specific to Q2 that Dave will discuss in more detail, was $0.2 million, or $0.01 per share. Excluding these two items, net income was $2.5 million, or $0.23 per share. This compares with net income for Q2 of last year of $2.6 million, or $0.25 per share. Adjusted EBITDA for Q2 increased 6% to $12.2 million. Finally, cash flow from operations was $8.9 million, up 28% from the second quarter of last year, and brings total cash flow from operations for the year to date to $23 million.

Domains

Turning to domains, Q2 was yet another solid quarter for our Domains business, underpinned by the consistency and profitability of this business, as we continue to reap the benefits of the economic transition to online commerce in response to the pandemic. Total gross margin dollars for the Domains business increased 7% year-over-year on a 1% decrease in revenue, as our focus on driving gross margin within this business continues to yield the intended results.

Our Wholesale Domains channel saw year-over-year growth in gross margin of 11%. Gross margin for the Domain Services component of Wholesale increased 14%, driven in part by higher total wholesale registrations, which increased 7% year-over-year to 4.3 million, from 4.0 million, with new registrations up a remarkable 41%. As expected, in Q2 we saw the full effects of the pandemic that we began to experience toward the end of Q1, with businesses globally moving quickly online, and displaced workers turning to entrepreneurship as the next stage in their career paths. A large proportion of that new registration activity was those resellers who focus on helping small and micro-sized businesses and start-ups establish a web presence for the first time. And remember, the financial benefit of this increased activity will be spread out over the next several quarters due to the deferral of revenue on these transactions. In addition, Wholesale gross margin continued to benefit from our success in focusing on high-quality, higher gross margin customers.

Importantly, amidst this tumultuous macro environment, our Wholesale renewal rate held steady at 78%, where it has been now for three quarters straight, remaining solidly above the industry average. This is continued evidence of the quality of both our resellers and the high attachment rate of their domains to real businesses.

For Value Added Services, we saw our fifth consecutive quarter of year-over-year growth in gross margin dollars, at 6%. This is even more impressive than the double digit growth of the last four quarters, given that the changes we made to the expiry stream last year are now more than 12 months behind us.

Our Retail Domains channel, like our Wholesale channel, also experienced the benefit of higher transaction activity driven by the pandemic, with total registrations for Q2 up 9% year-over-year, to 400,000, and new registrations up more than 20%. This marked our second consecutive quarter of year-over-year growth in total transactions after several consecutive quarters of declines. These increases contributed to a gross margin for the Retail Channel that was essentially flat compared to Q2 of last year, as the benefit of the higher transaction volumes was essentially offset by the continuation of higher-priced Enom names naturally churning out.

The renewal rate for the Retail channel remained solidly above the industry average, and in fact, ticked up nicely in Q2 to 82% from 79% in Q1.

While we have continued to see strong year-over-year new registration activity in both Wholesale and Retail channels so far in Q3, those increases are not at the same remarkable levels that we experienced in Q2.

Finally on Domains, in early July we migrated our first registrations to our new platform and I am pleased to report that it went flawlessly. We will now look to accelerate the transition of registrations to the new platform. The exercise of building a new platform from a clean sheet is rare, and will always be difficult. We would certainly not have undertaken such a challenge had we not been in the position we were in, with two 20-year-old platforms, each with significant technical debt. The exercise, in addition to providing the technological foundation to support the success of the Domains business for the foreseeable future, has had the additional benefit of allowing us to re-architect a number of functions into shared services used across all three businesses -- such that the new platform will not only provide meaningful benefit to the Domains business, but also to the Mobile and Internet businesses. As we have seen with our announcement earlier this week, that work unlocks value across the whole Tucows business.

Mobile

For Ting Mobile, I will quickly highlight the key metrics for the quarter and then offer some more detail and clarity on the DISH deal that we announced earlier this week.

Service revenue for Q2 was down 16% versus Q2 a year ago, and 10% compared to last quarter. Gross margin on service revenue for Q2 was down just 2.5% versus a year ago and 1.8% sequentially. Revenue was impacted by a declining subscriber base, and the lower data usage per subscriber since COVID.

In Q2, we also shut down the Roam Mobility business which had primarily serviced Canadians traveling to the US for short-term business and vacations. Volume on this business had gone to zero since COVID, and the US-Canadian border closing. Q2 Mobile performance includes the loss of that recurring revenue and the one-time writedown of SIM card inventory and outstanding credits.

We finished the quarter with just over 150,000 active Ting Mobile accounts and just under 257,000 active subscribers, a loss of about 3,500 accounts and 15,000 subscribers with the outsized subscriber loss reflecting more of those low-contribution entertainment sector customers.

Churn for Q2 was 2.30%, down from 2.79% in Q2 a year ago and 3.17% last quarter. Our quarantined customers clearly saw the benefit of paying for just the cellular data they used.

So that sets the stage for the earn out we will get in the DISH deal. By deal close on August 1, our subscriber count was, as noted above, a little under 257,000. Churn on that legacy base will benefit from aging and expected lower pricing. Lower pricing of course also means lower gross margin as a tradeoff. You will see the payments received as a distinct line item on our reporting on the Mobile business going forward.

While we will be deeply focused for the next while on making DISH happy, longer term we plan to use our MSE platform to serve additional customers beyond DISH. We have had similar conversations with other large telecoms in the past and we have a pretty good sense of what this service landscape looks like, and we like the look of it.

As I mentioned on the last call, I expect the impact of this shift to be neutral to slightly negative on our Mobile financial performance this year. In the short term we stop spending money to acquire new subscribers, we shift resources from maintaining an MVNO to improving an MSE, and focusing on our core competencies. The ramp of our hiring will dictate the short term.

In the first half of 2021, we expect the combined cash flows from our earn out and MSE fees to start to exceed the cash flows we have been seeing in the Ting Mobile business and we expect this improvement to increase over time.

With the MSE business, there will be a real difference between the short term and the long term. In the short term we need to focus on scaling up the platform, handling the initial integration between the companies, focusing on the Boost migration, and learning about working with 5G networks. In the longer term, we will be focused on adding new telecom customers and making each customer as successful as possible in adding end users. In thinking about how investors should follow our MSE business, this should be your guide. We will be talking a lot about integration and the Boost migration for the first while, and then will start to switch to some of those longer-term metrics. We are very excited today about some of those long-term prospects, but that is a conversation for the future. We want you to know that we are thinking about it, but right now we're focused on the right short-term signposts.

I could not be happier with this pivot. We address our single greatest weakness; a cost structure that was making it increasingly difficult for us to compete in a space that was going to see even greater competition with DISH's entrance. We leverage our greatest strength: building and maintaining platforms that simplify complex business processes. We take a line of business that was declining, and we give ourselves a real opportunity to grow again. And we are doing it in a way that lets us have a greater impact on the US mobile phone market. We are proud and excited to get started.

Ting Internet

Moving on to Ting Internet, the second quarter is beginning to show the results of our efforts to structure the business to scale, with more records being set for many metrics. That being said, we view these as early and modest gains, and reinforcement of our work to create the structure to support accelerated growth. We will continue to step on the gas with respect to investment in fiber infrastructure and the business in general.

We spent $9.8 million in fiber capex in Q2. We passed 4,650 new addresses, an increase of over 64% over Q1, and 2,500 of those became serviceable, bringing us to a total of nearly 47,900 serviceable addresses. In Q2, we lit a new central office in Fuquay-Varina, which has enabled us to begin converting pre-orders to installed customers. As our construction continues apace in other markets in North Carolina and Centennial, Colorado, and we put final work into the completion of our central office facilities in those markets, our passed addresses have again outpaced serviceable addresses. We expect those central office facilities to come online late Q3 to early Q4, which will convert tranches of passed customers to serviceable, once completed.

As of Q2, Ting is now at 12,500 Internet subscribers. Although that number has increased from Q1, the Q2 numbers were impacted by our temporary suspension of new installs through most of April, due to concerns about COVID-19. You will recall that we implemented an installation review protocol and smart installation process on April 20th to enable us to connect customers without risk of transmission. We're pleased to report this has enabled us to return to an optimal installation cadence, and work through the backlog of orders due to increased demand for installations from the pandemic.

One other data point I'd like to call out, that I've spoken about previously, is we're starting to see the impact of greenfield development in our North Carolina footprint. This quarter our potential serviceable addresses in that market jumped by 4,830, of which the majority are new potential addresses planned or being built to meet the growing demand for housing in the Raleigh area.

I now want to update you on a change in our approach to video. Again, our calculation was always how much we would need to spend on a traditional linear television product versus how many customers that would get us, that would not come to Ting Internet otherwise. For the past couple of years, it still seemed worth the investment. We now think the calculation has materially changed. The value and choice of over the top, or OTT, solutions has greatly improved and there are more ways for people to get the local channels and sports they need. Cord cutting has accelerated and seems to be ramping further since COVID. AT&T, for example, just reported its fourth straight quarter of roughly 5% churn on its traditional Premium TV subscribers. 20% in the past year! Demand for our fiber Internet is even stronger than we might have expected, with so many people increasingly working from home. Finally, I will admit that managing a traditional TV service – from third-party relationships to engineering to monitoring to support – seems like more of a burden than we had originally thought. For all these reasons, the effort and investment in a traditional linear television product no longer seems worth the incremental customers it would earn us. Instead, we are going to embrace an OTT solution or multiple solutions and do everything we can to make that complement as compelling and comfortable as we can for our Internet prospects and customers. With these changes, and the changes in the landscape more generally, we do not expect this to impact our take rate goals.

We wrote off net costs of roughly $1.5 million related to the satellite hardware, middleware and set-top boxes. But we feel really good about taking a step back and re-evaluating the additional upfront and recurring investments we might have wrongly made going forward. And, most importantly, we think our customers will spend less and have a better experience.

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 will have the first Ting customers lit there in August.

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 net revenue for the second quarter of 2020 was $82.1 million, a decrease of 2% from $84.1 million for the second quarter of last year. Strong growth in Ting Internet revenue was more than offset by a decrease in Ting Mobile revenue.

Cost of revenues before network costs decreased 6% to $51.8 million, from $54.9 million for Q2 of last year, with the decline primarily due to the lower revenue. As a percentage of revenue, however, cost of revenues before network costs declined by more than 200 basis points, to 63% from just over 65%, primarily due to an improved margin mix for the domains business.

Gross margin before network costs for the second quarter increased 4% to $30.3 million, from $29.2 million, or, as a percentage of revenue, increased to 37% from 35% for Q2 of 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 second quarter increased 8% year-on-year to $18.7 million, from $17.4 million in Q2 last year. As a percentage of revenue, gross margin for Domain Services increased to 31% from 29%.

Within the Domain Services business, gross margin for the Wholesale Channel increased 11% to $14.1 million, from $12.7 million for the second quarter last year. As a percentage of revenue, gross margin for Wholesale increased to 28% from 25%. Again this quarter, the increase, on both an absolute dollar and margin basis, was primarily the result of our continued success in managing the Domains business for gross margin, in particular, our focus on high quality customers.

Gross margin for Retail Domain Services decreased by less than 1% to $4.3 million, from $4.4 million in Q2 last year but, as a percentage of revenue, increased slightly to 51%, from 50%.

Turning now to Network Access, gross margin for the second quarter increased 3% to $12.9 million, from $12.5 million in Q2 last year, with a decrease in Mobile gross margin of $1.3 million, or 13%, being more than offset by the increase in Other Services of $1.7 million, or 72%. The decrease in Mobile gross margin was primarily driven by a Covid-19 related impact on our Roam Mobility business as business and leisure travel came to a halt starting in March of this year. Including the impact of the shut-down costs, the year over year gross margin decline for Q2 was $0.7 million for the Roam mobility business. The increase in Other Services was the result of both the incremental contribution of the Cedar Networks acquisition completed January 1st of this year, which contributed $1 million, as well as continued growth in the Ting Internet subscriber base.

As a percentage of revenue, gross margin for Network Access increased to 59% from 53% in Q2 of last year, with Ting Mobile increasing to 51% from 49%, and Other Services ticking up slightly up to 90%, from 88%.

Turning now to costs, network expenses for Q2 2020 increased 57% to $5.1 million, from $3.2 million in the same period a year ago. The increase is primarily due to the impairment of TV related hardware and software assets totalling $1.5 million. The remainder of the increase was 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 second quarter of 2020 increased 14% to $21.4 million, from $18.8 million for the second quarter last year. The increase is due primarily to the following:

- Excluding the impact from the acquisition of Cedar on January 1st of this year, people costs increased by $0.8 million, primarily from an increased workforce to support business expansion, including the Ting Internet build-out, $0.2 million from higher anticipated performance bonus payments year-to-date versus last year, due to improved business performance and a $0.2 million increase from higher accrued vacation expense, as Covid-19 has had a notable delayed usage impact. These were 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.
- Cedar related expenses added $0.5 million to the quarter, primarily workforce related.
- Marketing costs decreased by $0.4 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 an ongoing reduction in business volumes related to COVID-19.

- Contractor and third-party costs, including professional fees, increased $0.1 million, while costs related to travel and other discretionary expenses decreased by $0.3 million
- Amortization of intangible assets increased by $0.3 million, which related primarily to the set-up this year of intangible assets for the Cedar customer relationships and network rights totalling $5.6 million.
- We also had $1.4 million of impairment of intangible Assets related to the shut down of the Roam mobility business this quarter, related to the customer relationship asset set-up as part of the 2017 acquisition.
- And lastly, there was a $0.2 million net increase in expenses related to foreign exchange impacts. Specifically, we had a gain of $400K in Q2 2020 related to mark-to-market remeasurements for our forward currency contracts that do not qualify for hedge accounting, compared to a neutral impact in Q2 of last year, resulting in a year-over-year expense decrease of just over $0.4 million. In addition, we experienced a loss of $0.5 million on the revaluation of foreign denominated monetary assets and liabilities this quarter compared to a gain of $0.1M in the second quarter of 2019, which had the impact of increasing our expenses $0.6 million on a year-over-year basis.

As a percentage of revenue, total operating expenses increased to 26% from 22%, but would have increased to only 24% if excluding the impact from the Roam mobility impairment.

Net income for the second quarter of 2020 was $0.2 million, or $0.01 per share, which as Elliot noted, included the impact of two non-cash, non-recurring items specific to Q2 -- one for the shut down of Roam Mobility -- and the other related to our shift in our TV strategy for the Fiber business. Together, these totalled, on an after-tax basis, $2.3 million, or $0.22 per share. Excluding the two non-cash, non-recurring items, net income for Q2 of this year would have been $2.5 million, or $0.23 per share. This compares with $2.6 million, or $0.25 per share for Q2 last year.

Adjusted EBITDA for the second quarter increased 6% to $12.2 million, from $11.5 million, for Q2 last year.

Turning to our balance sheet and cash flows, cash and cash equivalents at the end of the second quarter of 2020 was $8.9 million, compared with $12.4 million at the end of the first quarter of this year, and $12.0 million at the end of the second quarter of last year.

During Q2 of this year, we generated $8.9 million in cash from operations compared with $7.0 million in Q2 last year. Cash from operations was offset by our investment of an additional $12.2 million in property and equipment, primarily related to the Ting Internet build out.

We also used $167,000 under our open market buyback program, purchasing 3,500 shares at an average price of $46.87.

Deferred revenue at the end of the second quarter was $155 million, up from $153 million at the end of the first quarter of this year, but down from $157 million at the end of the second 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.

I noted in our commentary published concurrently with the Ting-DISH announcement that we expect the deal to be neutral to slightly negative for 2020 EBITDA, and are therefore leaving our guidance for the year unchanged at $50 million.

With the Ting Mobile-DISH transaction announced earlier this week, we can start to better see how our three businesses fit together.

From the time we announced our entry into the mobile phone market nearly ten years ago, we have been explaining the connection between our roots in domain registration and our entry into the billing business. In both spaces, we were doing excellent work in billing, provisioning and customer experience. Mobile was attractive as it has much higher margins and was a much larger market.

Today, we have, in some sense, three distinct businesses: domains, mobile and fixed Internet. But they are all built on one common set of competencies -- billing, provisioning and customer experience. We just apply them to different problems.

I noted in my opening remarks that we were now deploying the new domains infrastructure, and I referenced benefits across all three of our businesses. We were moving from somewhat monolithic architecture to a more modern, event-driven approach. And in deploying that new domains infrastructure, we also teased out functional elements, like payments, that were common across all three platforms.

It is also the case that the transition in mobile from retail to MSE will lead to a further separation of functions both between mobile and fixed Internet and between those service platforms, and the set of services shared across all platforms.

Many long-time investors know that we have a small ISP billing business tucked inside of our Internet business. And many of you know that I have always harbored a desire to provide that functionality -- billing, provisioning and customer care -- to other fiber Internet providers, both in the US and around the world.

In each of these segments we have a window on the distinction between retail and wholesale. Generally, retail requires all of the elements of a platform, plus marketing and frontline customer service (as distinct from customer experience). In each of these segments, the retail businesses are very different from each other. They each have very different competitive characteristics, macro market characteristics, marketing dynamics and complexity in the frontline customer service experience.

In each of these segments, there is a lot of commonality in the billing, provisioning and customer experience provided by a platform. These SaaS platforms are distinguished generally by the provisioning. And the key to excellence in these platforms is a deep understanding of the subject matter and the specific business processes that make up the customer experience. In order to be great at a platform, one needs to be deeply intimate with the business processes that make up the service.

At Tucows, much of our core DNA comes from the early days of the dialup ISP business. Those are my roots, as well as the roots of a number of other key employees. We understand the business processes of running an ISP intimately. We understood domain names because at the time we created OpenSRS, it was ISPs around the world who primarily sold domain names. We understood mobile because we viewed it as essentially an ISP with mobility. All of that is to say, because of history and experience, we believe we are incredibly well suited to be delivering these platforms.

We love platform businesses. They are incredibly consistent and reliable. They generally have high switching costs therefore a nice moat around the business. Consistency, reliability and growth, particularly in a yield-starved world, feel quite good to us.

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 August 12th, and look for our recorded Q&A audio response and transcript to this call, as well as the recent DISH partnership announcement, to be posted to the Tucows website on Monday, August 17th at approximately 4 p.m. eastern time. Thank you.
