Tucows Q2 2021 Management Remarks Transcript

Introduction [Monica Webb, Senior Director, Market Development and Strategic Partnerships]

Welcome to Tucows' second quarter 2021 management commentary. We have pre-recorded prepared remarks regarding the quarter and outlook for the Company. A Tucows-generated transcript of these remarks, with relevant links, 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 11. Management will address your questions directly, or in a recorded audio response and transcript that will be posted to the Tucows website on Tuesday, August 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 six quarters, as well as for 2019, 2020 and 2021 year to date, is available in the Investors section of the website, along with the updated Ting Build Scorecard and Investor Presentation.

Now for management's prepared remarks:

On Thursday, August 5, Tucows issued a news release reporting its financial results for the second quarter ended June 30, 2021. 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, Elliot Noss. Go ahead Elliot.

Management Remarks [Elliot Noss, President and Chief Executive Officer]

Q2 Results Summary

Thanks Monica. Q2 marked another quarter of solid performance for Tucows overall, and for each of our three business segments. Our Domains business is benefitting from the impact of the growth in domains under management generated by the pandemic impact last year, as well as the continued impact of our focus on maximizing gross margin and overall profitability. Mobile Services is moving forward on plan and contributing in line with our expectations for the MSE model. And Internet Services saw another quarter of record performances across key metrics, including by far our largest capex spend, passed addresses and growth in the subscriber base.

Turning to our financial results, I will again remind you that for comparative purposes, our reported revenue and gross margin do not include results from our legacy mobile customers, with almost all of that revenue and much of the expenses associated with the Mobile business now subsumed in "Other Income." Those looking for a refresher on the details can refer to our Q3 2020 management remarks.

Net income for the second quarter was $1.8 million, or $0.17 per share, compared with $200,000, or $0.01 per share, with a reminder that Q2 last year included non-cash, non-recurring charges that when excluded, resulted in net income of $2.5 million or $0.23 per share, as increased spend on opex to fuel growth in our two growth businesses, and increased non-cash charges from our capex spend drive this number lower.

Cash flow from operations was $3.5 million compared with $8.9 million in Q2 last year, primarily impacted by the operational investments in Ting Fiber and a number of other items that Dave will discuss in more detail in his section.

And Adjusted EBITDA was $11.2 million compared with $12.2 million in Q2 last year.

Excluding the impact of the change in how our Mobile results flow through the income statement due to the shift to the MSE model, revenue for just the Domains and Fiber Internet businesses for Q2 increased 5% year-over-year to $68.1 million, and Gross Margin for Domains and Fiber was up 4%, to $22.3 million.

Total revenue for the second quarter was $75.1 million, compared with $82.1 million for the same period last year, and total gross margin was $18.2 million, compared with $23.0 million in Q2 last year. The decrease in each is the result of the shift in our Mobile Services business to the MSE model in early August of last year.

Domains

Turning now to our individual businesses -- starting with Domain Services -- Q2 was another solid quarter, once again highlighting the overall consistency of the business. Revenue and gross margin were both up 4% year over year, with Adjusted EBITDA up just over 3%, to $12.8 million. With the outsized transaction volumes generated by the pandemic having dissipated, the business has settled into a healthy new steady state level, as we continue to benefit from our focus on the quality of our customer base to optimize gross margin, as well as operating the business efficiently.

In our Wholesale Channel, we saw year-over-year growth in both revenue and gross margin -- 5% and 9% respectively.

In the Domain Services component of the Wholesale Channel, having now emerged from the period of pandemic benefit -- and given the outsized Q2 last year, it makes some sense to look at transaction performance for Q2 this year compared to that of Q2 2019. Total registrations for Q2 of this year were 4 million, more or less the same as that for Q2 2019, but down 6% from the pandemic-related highs of last year. Renewals were up 7%, benefiting from the pandemic spike in registrations, and the renewal rate for the Wholesale Channel for Q2 was 77%, down as expected from our recent historical levels of around 80%, due to the outsized number of first-time renewals. The renewal rate, however, is still above the industry average, and we expect it will return to normal next year. New registrations were down 37%, as new registration activity returned to more normal levels. Importantly, however, revenue for the Domain Services component of Wholesale was up 4% with gross margin up 3%.

The Value-Added Services component of the Wholesale Channel had another very strong quarter, which saw revenue increase 16% and gross margin 22% year over year, driven mainly by the continued strong performance from our expiry stream business that I noted on our last call.

In our Retail Channel, total registrations were about 370,000, essentially flat compared to the the second quarter of 2019, but up 8% when we correct for the transition in Q2 of this year of several hundred Enom customers with nearly a quarter million domains from our Retail business to the Wholesale business, where they will be better serviced. This is part of our ongoing strategy to simplify the Domains brand structure. Compared to Q2 last year, again correcting for the transition of the Wholesale names to Retail, total transactions were essentially unchanged from Q2 last year and new registrations were down 10%, again with Q2 last year being an outsized quarter due to the pandemic. The Retail renewal rate was

85%, down slightly from 86% for the first quarter of this year. It also remains solidly above the industry average.
Gross margin for the Retail Channel for Q2 was down 9% from the same period last year -- a combination of an accentuation of the trend we have discussed in previous quarters, and the transition of the customers from Retail to Wholesale that I just mentioned.

Five quarters now from the start of the pandemic, I am pleased with both our performance throughout this period and the current state of business.

Mobile

In the mobile business, we continue to focus on our work for DISH, both in continuing to meet milestones for the MSE platform -- and providing services to DISH under our TSA. We're fulfilling the requirements to the high standards Ting has become known for under the TSA.

The legacy Ting customer base that DISH now owns is performing well relative to our expectations and our assumption of more aggressive pricing leading to high retention rates has proven to be correct.

Importantly, on July 19, DISH announced the signing of a long-term strategic Network Services Agreement with AT&T, making AT&T the primary network services partner for DISH MVNO customers. Through this agreement, DISH will provide current and future customers of its retail wireless brands, including Boost Mobile, Ting Mobile and Republic Wireless, access to AT&T's wireless network, in addition to the new DISH 5G network. The agreement accelerates DISH's expansion of retail wireless distribution to rural markets where DISH provides satellite TV services. For us this is further evidence that DISH is making all the necessary moves to grow their customer base and deliver on becoming the fourth major mobile player in the U.S. I will share more thoughts on this in my closing comments. One thing to note here is that this will postpone the already delayed settling into steady-state for this business even further, but for the best of business reasons -- for both DISH and us -- as their success is our success.

Last quarter we mentioned the issue with T-Mobile forcing Sprint subscribers to migrate by the end of the year, costing every provider with those subscribers, (including Ting and Boost subscribers), time and money to address the migration requirements in a compressed amount of time. This impacts both our work and our revenue flows, and as I've advised previously, the best information on the Ting Mobile and Boost bases will come from DISH disclosures. This is still outstanding, although again, DISH moving from a shotgun marriage with T-Mobile to one built on a real long-term relationship with AT&T should help mitigate.

Ting Internet

Moving on to Ting Internet, we are really starting to see our work to scale the business come to fruition. In Q2, we hit a milestone of 20,000 subscribers. To put in context how the pace of our business has accelerated, we hit 10,000 subscribers in Q4 of 2019, at the end of 5 years in the business, and 15,000 in Q4 of 2020. This quarter was also our largest net gain of subscribers to date, at an increase of 55% in Q2, from Q1.

We also set a record with our largest increase in passed addresses to date, with 6,900 new addresses in Q2 from Q1, bringing us to a total of 77,200 passed addresses, and 71,400 serviceable addresses.

Our capex investment also continues trending upwards with a 17% increase in Q2 from Q1, and 67% compared to Q2 last year. I like to remind investors that our efforts to scale and grow have a material burn associated with them, as we focus on building capacity, hiring, and laying in the primitives that will allow our ISP business to scale with continued high levels of customer satisfaction. Seeing how this work is transforming the business and setting the stage to build and generate revenue faster, and operate more efficiently, I'd have to say I have never enjoyed losing money so much.

To that point, we recently lit our network in Culver City, California with service. This is the fastest market we have planned, built, and lit, to date. We publicly announced the market Nov 17th, 2020, began building the network, using microtrenching, at the beginning of March, and then added our first live customer to the network July 20th. We are also now using microtrenching to expedite the remainder of our deployment in Centennial, Colorado, and as a result, we expect to complete the build there in the first half of 2022.

I am extremely pleased to see our business KPIs accelerating, but as I've said, we are continuing to implement and refine processes that will allow further acceleration of these metrics.

We are refining both our build machine and our operation for maximum efficiency, visibility and scalability. We continue to integrate tools that automate, track and provide robust visibility into our network operations, and that help streamline much of our pre-network build work. We're ensuring our supply chain is secure. And our microtrenching practice continues to expand. I do want to remind investors that microtrenching for us is about reducing time to build and bring on customers -- it's not about reduced cost. You will recall my mention of the vastly increased interest from capital sources in building fiber markets. This has accelerated the timelines across the country for us to find and build markets, and

microtrenching is a critical tool for us to deploy quickly. Many of you have also heard me say that I am looking for time, not money, when evaluating partners and opportunities.

I would also like to mention Ting's inaugural foray into leveraging government funding to increase affordability of broadband access, as one of the first cohort of industry players supporting the Emergency Broadband Benefit, or EBB. It's funded by $3.2 billion allocated by Congress in the December 2020 stimulus package, and aims to help Americans struggling to pay for broadband internet service during the pandemic. As part of the EBB, eligible Ting Internet customers will receive up to a $50 monthly credit on their internet bill for the duration of the program. We were able to implement the necessary internal processes to enable participation in the program, and launched it as soon as it was available in May, immediately signing up customers. We saw the first funds flow to us from the government in June.

Importantly -- unlike most every other provider -- what we are providing under this program is a full symmetrical gig, subsidized. We do not believe that those on the wrong side of the digital divide, have less needs or deserve worse internet than those on the other side.

I will share more on the regulatory environment in the close as well.

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...

I want to remind you at the outset that beginning in Q1 of this year we reorganized our reporting structure into three segments: Fiber Internet Services; Mobile Services; and Domain Services -- for each of which we are now reporting down to the Adjusted EBITDA line. Certain corporate costs are excluded from the Adjusted EBITDA for each segment as they are centrally managed. These include: Finance; Human Resources; Legal; Corporate IT; depreciation and amortization expense or impairments; interest expense; stock-based compensation and other income; and expense items not monitored as part of our segment operations. Our comparative period financial results have also been reclassified to reflect the new segment structure, and prior period segment Adjusted EBITDA results provided.

In addition, as Elliot noted at the outset, our second quarter results once again reflect the impact of the transition of our Mobile business to the MSE model on August 1st of last year. As a reminder, as a result of this transition, gross margin now consists of only the legacy

Mobile retail customer base that was not sold to DISH, and therefore decreases significantly year over year. Or, more accurately, Tucows no longer owns, and therefore does not benefit from, the margin on the growing portion of that base. Operating expenses also decrease because we eliminate retail spends and transition retail staff with staff intended to build and operate a wholesale business. All of the revenue associated with the customer relationships that were sold to DISH, and much of the expenses associated with the previous Mobile retail model, are now included as "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 the operating performance of the overall Tucows business.

Turning now to the results.

Total revenue for the second quarter of 2021 was $75.1 million, a 9% decrease from $82.1 million for the second quarter of 2020. The decrease is the result of the sale of the Ting Mobile customer relationships on August 1 of last year. That decrease was partially offset by continued strong growth in Ting Fiber Internet revenue -- up $1.4 million, or 32%, year over year -- as the subscriber base continues to grow, as well as growth in our Domains business of $2.1 million, or 4%, year over year.

Excluding the impact of the shift in the Mobile business to the MSE model that I described a moment ago, revenue for the combined Domains and Fiber Internet businesses increased 5%.

Cost of revenues before network costs for Q2 decreased 5%, to $49.1 million from $51.8 million for the same period last year, with the decline primarily due to the lower revenue. As a percentage of revenue, cost of revenues before network costs increased to 65% from 63%. The increase as a percentage of revenue is mainly due to a mix shift that saw higher Fiber revenue relative to lower Mobile revenue.

Gross margin before network costs for the second quarter decreased 14% year over year to $26 million from $30.3 million, with the entirety of the decrease again attributable to the sale of Ting Mobile customer relationships. As a percentage of revenue, gross margin before network costs decreased to 35%, from 37% for Q2 last year.

Once again excluding the Ting Mobile business for a more relevant year-over-year comparison, gross margin before network costs for the combined Domains Services and Fiber Internet Services businesses was up 4% year over year to $22.3 million.

I'll now review the individual gross margin for each of the Domain, Mobile and Fiber Internet Services business.

Starting with Domain Services, gross margin for the second quarter of 2021 increased 4% to $19.5 million, from $18.7 million for the second quarter of last year. As a percentage of revenue, gross margin for Domain Services was unchanged from Q2 last year, at 31%.

Within the Domain Services business, gross margin for the Wholesale Channel increased 9% to $15.1 million, from $13.9 million for Q2 last year. The increase is the combined result of year-over-year growth in the number of Domains under management and our success in managing the business for gross margin.

As a percentage of revenue, gross margin for Wholesale increased to 28%, from 27%.

Gross margin for the Retail Channel of Domain Services decreased 9% to $4.4 million, from $4.8 million for Q2 2020. As Elliot mentioned earlier, much of this decrease was the result of the transition in Q2 of this year of a significant number of Enom customers and their domains from our Retail business to our Wholesale business. As a percentage of revenue, gross margin was 49% compared with 52% in Q2 last year.

For Mobile Services, gross margin was $3.7 million compared with $8.9 million in Q2 last year, with the difference primarily attributable to the sale of the Ting Mobile customers to DISH. I will note here that the $3.7 million for Q2 this year is up significantly from $1.5 million in Q1, as during the quarter we recognized revenue on bundled professional services included as part of the MSE platform fees.

As per the accounting treatment of the DISH transaction, we generated a Gain on the Sale of Ting Customer Assets of $4.8 million, which represents the earn out on that customer base and is recognized on the income statement as, "Other Income".

For Fiber Internet Services, gross margin increased 2% to $2.8 million, from $2.7 million in Q2 last year. As I explained last quarter, gross margin is impacted by a number of factors and cost drivers that are incurred prior to subscriber revenue being generated; hence the relatively modest increase relative to the increase in the subscriber base over the same period. A quick reminder. Cost of revenues includes the following: network access fees paid to third-parties to use their network, such as our partnerships in Westminster, Fullerton and Solana Beach; bandwidth costs; the personnel and related expenses (net of capitalization) related to the physical construction and build out of the Fiber network; and as well as personnel and related expenses (net of capitalization) related to the installation, repair and overall field service delivery of the Fiber business. Hardware costs include the cost of equipment sold to end customers, including routers, ONTs, and IPTV products, and any adjustments on the inventory of these items. Other costs include field vehicle expenses,

and small sundry equipment and supplies consumed in building the Fiber network. As a percentage of revenue, gross margin for Fiber Internet decreased to 48% from 62%. The decrease is primarily a factor of the timing of revenue relative to the incursion of costs.

Network expenses for the second quarter of 2021 increased 5% to $7.7 million from $7.4 million for the same period of last year. I will remind you that Q2 last year included a write down of $1.5 million related to Ting TV. Excluding that write down, network expenses were up 30% year over year.

Overall, operating expenses for the second quarter of 2021 decreased 5% to $20.3 million, from $21.4 million for the second quarter last year. Excluding the one-time non cash $1.4 million impairment of intangible Assets in Q2 2020, operating expenses were up $0.3 million or 1.5%. The increase is the result of the following:

- People costs were up $0.5 million this quarter, with increased workforce costs to support business expansion, including Ting Internet growth and MSE platform build, offset by certain mobile costs related to the legacy subscriber base being included in Other Income;
- Marketing costs and credit card fees decreased by $0.3 million each, mainly driven by the transition of the mobile business, while bad debts decreased by $0.1 million;
- Stock-based compensation increased $0.3 million and professional fees were up $0.2 million;
- Amortization of intangible assets decreased by $0.2 million, due to the write-down of the Ting Mobile Roam Mobility related assets last year;
- And lastly, there was a $0.1 million net increase in expenses related to foreign exchange impacts. Specifically, we had a loss of $0.1 million in Q2 2021 related to mark-to-market remeasurements for our forward currency contracts that do not qualify for hedge accounting, compared to a gain of $0.4 million in Q2 of last year, resulting in a year-over-year loss of $0.5 million. In addition, we experienced a loss of $0.1 million on the revaluation of foreign denominated monetary assets and liabilities this quarter compared to a loss of $0.5 million in the second quarter of 2020, which had the impact of decreasing our expenses $0.4 million on a year over year basis.

As a percentage of revenue, operating expenses increased slightly to 27% from 26%.

Net income for the second quarter of 2021 was $1.8 million, or $0.17 per share compared with $0.2 million, or $0.01 per share for Q2 2020. As Elliot noted at the outset, net income for Q2 last year included non-cash, non-recurring charges that when excluded, resulted in net income of $2.5 million or $0.23 per share. Excluding the non-recurring charges from Q2 last year, the year-over-year decrease in net income is primarily the result of lower EBITDA

due to the Ting fiber investments, higher amortization of our Fiber network build which reflects in the higher year-on-year network expenses and to a lesser extent higher interest costs offset by a lower effective tax rate in Q2 2021.

Adjusted EBITDA for the second quarter of 2021 was $11.2 million, down 8% from $12.2 million for Q2 last year.

That number includes $3.6 million of expense that is related to Corporate Shared services, which compares to $3.0 million for the same period last year. The remaining positive $14.2 million for Q2 2021 breaks out amongst our business segments as follows:

Adjusted EBITDA for Domains Services for Q2 increased 3% year over year to $12.8 million from $12.4 million in Q2 last year.

Adjusted EBITDA for Mobile Services increased 37% year over year to $5.3 million from $3.9 million. With the impact of the transition to the MSE model, the Adjusted EBITDA line is the best indicator of the year-on-year performance of our Mobile business given the change in the model. The increase was driven primarily by the increase in professional services revenues that I described earlier.

Finally, adjusted EBITDA for Fiber Internet Services for Q2 was negative $3.3 million compared to a negative $1.1 million in Q2 last year. The higher EBITDA loss is the result of the higher costs required to support the accelerated expansion of the Fiber business.

Turning to our balance sheet, cash and cash equivalents at the end of Q2 were $7.3 million, down from $8.3 million at the end of the first quarter of this year and down from $8.9 million at the end of the second quarter of last year.

During Q2, we generated $3.5 million in cash from operations compared with $8.9 million in Q2 last year. There were a number of factors that impacted the Q2 cash flow from operations, with the majority related to our Fiber Internet build, including an increase in the year-over-year cash EBITDA investment in Fiber Internet, higher inventory and prepaid balances, and higher Canadian tax installments in Q2 2021 as the Canadian Revenue Agency allowed deferral of monthly installments in Q2 of last year during the early days of the pandemic. All of this was partially offset by better accounts receivable collections.

We also drew down $18 million on our loan and generated a net $1.2 million from the exercise of stock options. These sources of cash were offset by our investment of $24 million in property and equipment and other Fiber investments, primarily related to the Ting Internet build out, as well the on-going MSE platform build.

Finally, deferred revenue at the end of the second quarter was $155 million, down 2% from $158 million at the end of the first quarter of this year, and effectively flat as compared to 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 wanted to start by hopefully being able to welcome a new board member, Marlene Carl, in September, subject to the results of our AGM. She brings a wealth of experience in capital structures relating to infrastructure in general, and fiber in particular.

She is standing for election in the seat currently held by Rawleigh Ralls. Rawleigh has generously served Tucows since 2009, and has been instrumental in helping me understand the needs of shareholders. We all give him a big thanks for all his time and effort, and wish him the best in his future personal and professional endeavours.

I will also note with a solid second quarter both operationally and financially, we reiterate our guidance for 2021 of $43 million in Adjusted EBITDA.

Last quarter I shared my thoughts on the macro environment in fiber, all of which points to a huge fiber buildout, over the next five years in particular. This quarter I want to look a bit more at the micro.

First, we continue to see serious attention being paid to broadband stimulus in the US. We are pleased to see more focus on affordability. Over the next quarter or two we hope to see these policies clarified so we can integrate them into our operating plans. We expect this to impact how we approach the less dense areas surrounding our current builds and the programs we are able to put in place to help address the serious digital divide issues in the US.

We have seen a number of private equity firms invest in a platform, an executive team, and an existing operation, which can serve as the basis for building a large number of fiber passes and for acquiring smaller ISPs. What is certainly true is that when you look at the plans of incumbents like AT&T and Frontier, and then what I imagine is the sum of the number of customers built or acquired in the spreadsheets of all of these corporate development teams, it totals to many times the number of actual households in the United

States. Thus smart, nimble moves on the ground are at a premium. As is keeping a sober view.

We are now seeing more deal flow from mid-sized and smaller ISPs. I have talked about five years of building, and then five years of consolidation. We could see more of these two things happening in parallel. Most importantly, when, how, and why to partner and buy, will be at an even greater premium.

Probably the biggest news in US telecom this quarter is the AT&T/DISH deal. I will not recount the details here as it has been well covered. But I will share what this means through our eyes.

First -- and most importantly -- this is an important affirmation of what DISH is doing. We have talked previously of bets in our DISH deal paying off. We have talked about this in the context of how we dealt with our legacy subs; in terms of how we dealt with the brand; and in terms of how we approached 5G. But of course, the biggest bet of all is on whether or not DISH will be successful, and I think that this AT&T deal is a huge validation of that bet.

It was interesting in this regard that the most critical feedback I have seen has been that AT&T, “let DISH off the hook” with this deal. This suggests that leaving them with T-Mobile as a partner would have minimized DISH’s chances for success. It both says a lot of what the telecom industry, or at least one analyst, thinks of T-Mobile as a partner, and is also a VERY cynical view that puts the profitability of three companies ahead of the needs of 300 million Americans. Thankfully, AT&T’s position was, to paraphrase -- DISH will succeed with us or without us, so we may as well benefit from working with them.

The connective tissue tying together the fiber market and DISH/AT&T is the next generation of our ISP SaaS billing software. As this gets integrated into our MSE platform, it opens up a whole new set of opportunities. While this is still a few quarters away at least, I mention it here because it sits at the intersection of the huge opportunity to help other ISPs participating in the incredible coax-to-fiber transition that is now well underway -- and the horrible mess that is the current state of the telecom back office. We have now seen under the hood of a number of telecoms -- large and small -- and things are even worse than we expected. And we had very low expectations. And let’s be clear, this is the single greatest reason that larger telecoms in particular have such low customer satisfaction. And it is the single greatest reason why for the last ten years, our mobile and ISP customers have been the happiest telecom customers in the world.

I note this, as it is now evident to us that at some point the ISP software business will transition into our Mobile segment, combined with MSE. But that is just an accounting note

for down the road. At a business level, we see three long-term trends that we have talked about for years, coming together: The multi-generational transition from coax to fiber; the mess that is the telecom back office; and the integration of fixed and mobile networks.

We love our opportunities, both direct in the ISP space, and indirect -- helping telecoms around the world create happier customers, starting with DISH.

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