tucows

Tucows Q2 2022 Management Remarks Transcript

Introduction [Monica Webb, Senior Director, Investor Relations]

Welcome to Tucows' second quarter 2022 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 these remarks, shareholders, analysts and prospective investors are invited to submit questions to Tucows management via email at ir@tucows.com until August 16th. Management will address your questions directly or in a recorded audio response and transcript that will be posted to the Tucows website on August 31st 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 full years 2020 and 2021, and now also includes summaries of Fiber Internet Services' financial results and historical financial results, 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 Tuesday, August 9th, Tucows issued a news release reporting its financial results for the second quarter ended June 30th, 2022. That news release, and the Company's financial statements, are available on the Company's website at tucows.com under the Investors section.

Also note that the Company issued an additional press release this morning with material information on its Ting Internet business, which will be discussed in the following remarks. The release is available in the News section of the Tucows website.

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.

Finally, as discussed on our last call, starting in Q1 of this year, we started reporting as separate businesses—Ting, Wavelo and Tucows Domains–in addition to Tucows Corporate. Tucows

Domains is unchanged. Ting is also largely unchanged, save for our historical ISP billing solutions, which have been moved under Wavelo. Wavelo no longer includes the tail from the retail mobile customer base sold to DISH or the legacy retail mobile business. Both of these are now included in the Tucows Corporate category, as well as centrally managed administrative expenses. For those that have not done so, I encourage you to watch the video we posted in February for additional detail and perspective on the rationale for this change.

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]

Introduction

Thanks, Monica.

Q2 2022 was both a typical quarter for each of our three businesses as they continue to grow, and was a uniquely important quarter as we took on our first external investor and structured the businesses to accommodate their long-term capital needs.

A reminder that as part of changing our reporting by business segments, you will now hear directly from the heads of each business in these remarks, as well as from our CFO, Dave Singh, who will cover our financial results in detail.

The first speaker is Dave Woroch, Chief Executive Officer, Tucows Domains. Go ahead, Dave.

Tucows Domains [Dave Woroch, Chief Executive Officer, Tucows Domains]

Thanks, Elliot.

For the most recent quarter, I am pleased to report that Domain Services delivered another quarter of solid performance that continues to reflect the consistency of our business.

Revenue for Domain Services for the second quarter was down 2% from the same period of last year, and gross margin, absent a one-time accounting adjustment, was down 1%. Domain Services' adjusted EBITDA was unchanged from a year ago. These results reflect the operational efficiency of the business; the reliability of cash generation; our continued strength in the Wholesale channel; and the high quality of the domains that we manage.

Similar to my comments in the first quarter, while the overall financial performance of the Domains business was very much in line with Q2 of last year, total transactions for the business have continued at the lower, prepandemic levels that we have discussed for the past few quarters. And as with last quarter, we are seeing signs that this continues to be an industry trend. At the one end of the industry, the .com and .net registry recently cited a 14% year-over-year decrease in new registrations for their Q2. This follows a 12% year-over-year decrease in their Q1 and, more importantly, a sequential decline in total domains under management from Q1 to Q2. Other registries, including some legacy gTLDs and ccTLDs in mature geographies, are showing signs of limited growth in their domains under management. At the other end of the industry, we do see more robust growth in many of the new gTLDs that are of higher quality and that have little to no speculation or cyber crime opportunity.

Turning back to our business, in the Wholesale channel, revenue for Q2 was down 1% year over year, with gross margin also down 1%. Within the Wholesale channel, Domain Services' revenue was down 2% from the same period last year, while gross margin was down 1%. Revenue for the Value-Added Services component of the Wholesale channel was up 2% and gross margin up 1%, compared to Q2 last year. Worth noting, the gross margin from Domain Services and Value-Added Services is up 16% and 23%, respectively, when compared to Q2 of 2019 and pre-COVID.

In our Retail channel, revenue decreased 5%, while gross margin, absent the one-time accounting adjustment I mentioned earlier, also decreased 5% year over year. I will note here that we still saw some impact of the transition of a number of Enom customers from our retail channel to our Wholesale channel that occurred in Q2 of last year. This cycle has now run its course, and we do not expect this to have an impact on the business going forward.

And last, our combined overall renewal rate, at 82% in Q2 across all Tucows Domains brands, remains well above the industry average.

While our Domains business is consistent and reliable, it exists in a market that is, as I noted earlier, generally not showing a lot of growth. While we do expect the pandemic hangover to subside, we have always known that outsized growth would need to come from new areas.

Given that, we noticed with great interest the funding announcement for a company called Unstoppable Domains in the Web3 space. The company raised $65 million dollars at a $1 billion dollar valuation! This is more valuable than any domain name registrar other than GoDaddy.

At its simplest, Unstoppable Domains is offering domain name registrations in strings like .crypto and .nft. I do not want to get too technical in an investor call, but these domains do not work without special software that needs to be installed in order to use them. This is referred to as “using an alternative root.” People have been attempting to launch alternative roots since the ’90s, and there is simply too much of a chicken and an egg problem.

We have discussed our views on Web3 before. We are fans. What is most interesting about this news item is that it shows that investors have an appreciation for the relationship between domain names and identity. While we are not believers in this particular effort, we do think they are doing some interesting things—albeit with some fatal flaws—but nevertheless, we are thinking a lot about the relationship between domain names, identity and Web3.

I should note that of the three TCX businesses, Tucows Domains is the most clearly global and most deeply connected with core internet infrastructure. Investors should expect that any experimentation with Web3 in TCX is likely to be housed in Tucows Domains.

As I have more to share with you on the outcome of some of this experimentation, I will.

Now over to Justin Reilly, CEO of Wavelo.

Wavelo [Justin Reilly, Chief Executive Officer, Wavelo]

Thanks, Dave, and hello TCX investors.

First, the financial report. The majority of Wavelo’s revenues continue to come from the work with DISH and their customers. Q2 Platform Revenue was $9 million, up 31% from $6.9 million in Q1 and up 228% year over year. Professional services accounted for $1 million as we did another round of work for DISH to support their 5G rollout. As we conclude the bespoke work for DISH and move more customers onto the platform, this will shift our revenue towards a higher margin and more predictable subscription-based model. For decades, telecom providers have struggled to move away from professional services-based revenue models; we are laser focused on Wavelo operating as a subscription-based software company that produces SaaS economics. As discussed last quarter, this revenue is sticky, predictable and, most importantly, aligns our success with our customers’ success.

The migration of DISH’s Boost customers continued to take a backseat to other important work; however, we are now focused on this effort and expect to ramp up the migration cadence significantly over the rest of the year. As a reminder, the two most challenging parts of any telecom software deployment are network integrations and customer migrations. We've completed many of these over the years in many different service categories, leading to the happiest telecom customers in the world, and feel confident that we can help telecoms like DISH accelerate their moves away from legacy systems. We've also seen a bump in new, organic Boost subscribers DISH is putting directly on the platform. With respect to the number of subscribers expected to migrate to the Wavelo platform, in addition to the new customers DISH expects to add, as always, we recommend reviewing DISH's disclosures. We continue to believe strongly in the value of the world's first native 5G network and DISH's capacity for flexible pricing and packages to attract and retain customers. The beauty of Wavelo's multi-network platform—the only platform integrated with T-Mobile, DISH 5G, and AT&T—is that we can help DISH offer service nationwide right now as they build out their network in parallel.

The second half of the year is about launching new key features for our two anchor customers, DISH and Ting Internet, and building our go-to-market machine. For DISH, this is introducing features that help them compete across all customer types in their retail mobile business. For a decade in our mobile business, we blurred the lines between prepaid and postpaid, simply deciding to focus on the customer instead of antiquated industry norms. For Ting, we are finalizing the last features for the ISOS (Internet) platform and we're well positioned to launch in the next two quarters. Laying the groundwork for Ting to deliver the important promise of converged service to its customers throughout the country. This nicely allows Wavelo to be the first in the world to offer this service in a single platform. In addition, we expect to see our sales and marketing cadence pick up as we are seeing interest from global telecoms as they consider moving their operations software into the cloud. As a reminder, only 5% of telecoms have made this move–we are very early in their digital transformation.

As we prepare for customers beyond DISH and Ting, we're continuing to hire–aggressively, but thoughtfully. As the labor market evolves, we feel confident that Wavelo's mission and opportunity will attract makers and builders that want to impact atoms, not just bits. Finally, we recently relaunched our website as a hub for clients and prospects to engage with us. It will function as a home base for our sales and marketing activities. And I encourage you to check it out, at www.wavelo.com.

Thanks for listening, and now over to Elliot.

Ting Internet [Elliot Noss, President and Chief Executive Officer, Tucows]

Thanks, Justin.

Moving on to Ting Internet. In Q2, Ting put more fiber into the ground than ever before and continued to load customers onto the network at an impressive rate, staying on target with our aggressive growth plans.

In Q2, we added 2,500 net subscribers, taking us to 30,300 in total. We grew subscribers roughly 10% quarter over quarter, and 50% year over year. Our total for both Ting-owned and Ting Partner serviceable address additions was 5,600, taking us to nearly 104,000 total serviceable addresses.

Our fiber capex increased by 77% from last quarter, to $24.9 million. This increase reflects not only the conclusion of winter weather impact, but also our escalating build cadence. The turnover of serviceable addresses in the quarter isn't directly attributable to that level of investment, however, the fiber footage constructed in Q2 increased 70% from Q1. Much of that footage was built as middle mile transport that connected our networks in neighborhoods to central offices or data centers. That work will enable increased serviceable addresses in the next few quarters. We also passed more multi tenant units with fiber this quarter that our sales teams are working to gain entry and convert to serviceable addresses.

Starting last quarter, in page 2 of the KPI Summary, we provided new disclosure on mature vs. growth markets. We may have tried to pack too much into the metric. We will provide the comparable numbers, but going forward will change the disclosure. Like many things, both investors and us will likely learn more from the misstep than if we had nailed it the first time.

We want to present a view that lets investors see both how more mature markets grow as they load customers over time–and see the powerful net margins these businesses produce.

The first part is relatively easy. We track customer load by neighborhood. This allows us to see detailed take rates while differentiating between the ages of various neighborhoods. Expenses are trickier. We track expenses by footprint; for example: North Carolina or Charlottesville. While these footprints contain a significant number of mature neighborhoods, they also have a lot of new construction going on. In fact, in Q2 roughly 40% of the construction feet were in these two neighborhoods. Construction costs, market development costs, the rolling out of door to door efforts in some of these markets in newer neighborhoods, and other items have made the expense portion non representative. Going forward, we can easily show the top-line customer loading. We need to give more thought to how to best let investors see the operating leverage.

Looking at things through that lens, gross revenue grew by 6.2% quarter over quarter from roughly $5.3 million to roughly $5.6 million. I note this number now excludes both Cedar and Simply Bits which were included last quarter, but just obscure the benefit to investors as neither is currently a representative fiber market.

The last point I will make here is that the take rate curves in mature markets look more linear than parabolic at this point. That is extremely encouraging.

On another note, many of you will recall that as part of the 2020 DISH transaction, DISH had the option to acquire the Ting brand, and that option expired on August 1st. We're pleased they did not exercise it, and the Ting brand will be used exclusively by Tucows for our Internet business. While DISH is working through their migrations, we are continuing to let them use the Ting Mobile brand through the end of the year.

One final item, also related to the DISH transaction that I do want to cover, is the Verizon contract and corresponding customers, which are currently allocated to TCX. Investors may recall the contract and customers remained with Tucows as one of the loose ends after the DISH deal. We viewed there being a few paths at the time of the deal and factored in the worst case scenario when choosing to proceed. First, DISH may have chosen to partner with Verizon. They didn't and instead chose to work with AT&T. Second, we would attempt to sell the base. We did spend a fair amount of time pursuing this but for various reasons did not come to a suitable transaction.

Next, in the short term, our normal run rate for this business has started to tick below the minimum revenue commitments with the Verizon contract. We've been aware of this coming for some period of time, and accordingly, we plan to "make lemonade" from this situation by using that excess commitment, as, in essence, a marketing spend for Ting Internet.

Although the "lemonade" plan provides a way to use our Verizon obligations for internet customer acquisition, it also is consistent with something I've discussed for years: fixed/mobile convergence. Using fixed connectivity anytime it's available, and mobile only when you have to. And how bringing fixed and mobile together from a single supplier was likely an inevitable future.

In Q3, we have started to roll out unlimited mobile service to customers in Ting footprints at a shockingly low price. It's effectively the most compelling unlimited offering in the country, and in an increasingly competitive broadband market, we view this offering as a fantastic differentiator. We're already testing this in our Fullerton and Westminster markets, and are planning for more Ting markets over the coming months.

Two more things. First, this contract runs through 2025 and should dovetail nicely with DISH's ability to provide a wholesale network which will obviously provide options. Second, we expect this to be seamlessly integrated in the Wavelo platform, but not right away. In the nearer term, before this integration, the customer experience will be somewhat bifurcated, however, both short and long term, customers will be supported by the same customer experience team that gave Ting Mobile its reputation for outstanding customer service.

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.

Before I begin, just a note to remind investors that starting in Q1 of this year, the results for prior periods were recast to reflect the changes we made last quarter to the reporting segments to make the periods directly comparable.

Total revenue for the second quarter of 2022 increased 11% to $83.1 million from $75.1 million for the second quarter of 2021. The increase was driven by strong growth in both Ting Fiber Internet Services and Platform Services–up 84% and 228%, respectively–which were partially offset by the expected decline in revenue from transition services with DISH.

Revenue from Tucows Domains Services was down slightly to $61.1 million from $62.3 million in Q2 last year.

Cost of revenues before network costs for Q2 was essentially unchanged at $49.3 million as compared to $49.1 million for the same period of last year. As a percentage of revenue, cost of revenues before network costs decreased to 59% from 65%. This was primarily due to the growing proportion of high margin Platform Services revenues in the mix.

Gross profit before network costs for the second quarter increased 30% year over year to $33.8 million, from $26 million, with the increase due mainly to the higher gross profit contributions of both Platform Services and Fiber Internet Services. As a percentage of revenue, gross margin before network costs increased to 41% from 35%.

Breaking down gross profit by business, Domain Services' gross profit for the second quarter of 2022 increased 3% from Q2 last year to $20 million from $19.5 million. As a percentage of revenue, gross margin for Domain Services was 33% compared with 31% in Q2 of last year.

Platform Services gross profit increased 202% to $7.9 million from $2.6 million for Q2 2021, with the entirety of the increase being driven by revenues related to the Mobile operator platform. As a percentage of revenue, gross margin for Platform Services was 88% compared with 96% in Q2 last year.

Fiber Internet Services' gross profit for Q2 increased 128% year over year to $5.8 million from $2.5 million for the same period of last year. I will again remind you that gross margin for Fiber

Internet Services is impacted by a number of factors and cost drivers that are incurred prior to subscriber revenue being generated that can cause some variability from quarter to quarter.

As a percentage of revenue, gross margin for Fiber Internet Services expanded to 57% in the second quarter from 46% in Q2 last year. The increase is primarily due to the timing of revenue relative to the incursion of costs, including utilization of our field and engineering labor related to the delivery of our network.

Network expenses for Q2 increased 52% to $11.7 million from $7.7 million for the same period of last year. The increase was driven by both the higher depreciation of our fiber network assets, up 70% year over year, as well as the increase in our workforce to support the expanding fiber network.

Total operating expenses for the second quarter of 2022 increased 31% to $26.5 million from $20.3 million for the same period last year. The increase is primarily the result of the following:

- People costs were up $3.3 million this quarter, with increased workforce costs to support business expansion, related to Ting Internet growth, as well the continued Platform Services ramp, and to a lesser extent the acquisitions of Simply Bits as well as the UNR assets and its development team, both in October 2021. In addition, our annual performance and merit increases went into effect in May and were slightly higher on average than the prior year.
- Sales and Marketing costs increased by $1.3 million year over year, mainly driven by increased investments in the Ting Internet business, including Simply Bits.
- Facility and third-party contracting and support costs were up $1.2 million–primarily related to Simply Bits while Stock-based compensation increased $0.4 million.
- Amortization of intangible assets and loss on impairment of property and equipment increased $0.3 million.
- And lastly, foreign exchange impacts decreased expenses by $0.2 million this quarter driven by the year-over-year impacts from the revaluation of our of foreign denominated monetary assets and liabilities.

As a percentage of revenue, operating expenses increased to 32% for Q2 of this year from 27% for the same period last year.

We reported a net loss for the second quarter of 2022 of $3.1 million, or $0.29 per share, compared with net income of $1.8 million, or $0.17 per share, for the same period of last year. The net loss was driven predominantly by the accelerated build of our fiber network and ongoing ramp of the Ting Internet operations, as well as higher depreciation and interest expenses. Note–our tax expense reflects our geographic mix, with taxes payable in Canada on our legacy domains business.

Adjusted EBITDA for Q2 was $11.7 million, up 4.9% from $11.2 million for Q2 2021. That total breaks down amongst our three businesses as follows:

- Adjusted EBITDA for Domain Services was $12.1 million, unchanged year over year.
- Adjusted EBITDA for Platform Services was $3.9 million, up 435% from $0.7 million last year. I want to remind investors that this quarter, Wavelo again recognized revenue on bundled professional services included as part of the platform services provided to DISH. This recognition occurs either as the bundled hours are used or expire annually near the anniversary date of the DISH contract. We had a similarly lumpy recognition in Q2 2021. In addition, our financials reflect the recognition of a contract asset related to the non-cash revenue recognition of certain fixed payment components of the contract. The contract asset will unwind over the course of the term of the contract.
- Adjusted EBITDA for Fiber Internet Services was negative $6.2 million compared with negative $4.6 million in Q2 2021, with the larger loss reflecting expected costs required to support the accelerated expansion of that business.
- And finally, the Corporate category had positive adjusted EBITDA of $1.9 million compared with $2.9 million in Q2 last year, with the decline primarily driven by, and as expected, the lower earn-out from the sale of the Ting Mobile customers to DISH–as customers continue to churn–lower transition services margins and lower contribution from the mobile subscribers retained.

Turning to our balance sheet, cash and cash equivalents at the end of Q2 were $6.5 million, compared with $6.2 million at the end of the first quarter of 2022, and $7.3 million at the end of the second quarter of 2021.

During the quarter, we generated $12.6 million in cash from operations compared with $3.5 million in Q2 last year, with the increase being primarily due to a focus on working capital. We expect Q3 to reflect a return to more normalized working capital levels.

We also added $19.2 million to cash via a further draw down on our loan.

These sources of cash were more than offset by our investment of $30.3 million in property and equipment, primarily for the accelerated build-out of the Ting Fiber internet network, as well as the continued build of the Wavelo platform.

With the announcement of the preferred financing with Generate, we also entered into the third amendment of our existing credit facility. It remains at $240 million, with its maturity date extended to June 2024, and the modification of the leverage covenant to exclude the impact of the Ting Internet operations.

Finally, deferred revenue at the end of Q2 was $150 million, down 1% from $152 million at the end of the first quarter of 2022 and down 3% from $155 million at 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.

We'll start by talking about our recent financing.

This morning we announced a $200 million preferred equity financing with Generate Capital. The preferred equity carries a coupon of 15%, which could go as low as 13% and as high as 17%, based upon partnering on fiber markets we jointly pursue and develop with Generate. Generate has agreed to invest up to an additional $400 million in new networks, similar to the existing partnerships we have in Westminster, Fullerton, Solana Beach and Encinitas. The preferred equity has a term of six years. It only converts to common equity in the event of default, and the conversion price is $600 million dollars.

I will now share the features that made this particular deal, and this particular partner, stand out to us. First, we did not sell common equity and the preferred shares do not carry a conversion sweetener. Fiber businesses are essentially valued based upon the number of homes passed and the number of customers loaded onto the network. Given our rate of growth in capex and customers we felt we would do much better by delaying a sale of common equity.

Next, we value Generate as a partner due to their project management and development expertise via similar investments. Construction best practices, resource management, supply chain issues, and simply exposure to more data points in more footprints will make each group better at their craft. We have also established a strong city engagement team, which we can now utilize both for networks we intend to build with our own capital, and those where we choose to partner with Generate. We do believe we will comfortably meet the threshold necessary to lower the rate of the preferred equity to 13%.

It is fantastic to add that construction expertise in the short term, but in the long term we are more interested in Generate's core purpose. Generate established their reputation by using creative financial approaches to financing sustainable energy infrastructure like community solar, microgrids and waste-to-energy solutions. They are a true global leader in that regard. We have always viewed pervasive fiber as the missing piece to unlocking the potential of “smart cities."

The smart city movement is well over a decade old and while there have been advances, the potential still far outweighs the reality. In our view, the absence of pervasive fiber and the failure to integrate fiber with the rest of the sensor array that make up smart cities is the key reason why the promise has exceeded reality. In addition, we love the potential of microgrids and the ability of an ISP to be a key distribution point for microgrids. These are but two examples of the synergy between a fiber ISP and sustainability. Sustainability opportunities will be equally interesting to shareholders and employees at both a mission and finance level. Of course these initiatives are longer term, so do not expect to see anything in the next few quarters, but we expect to work closely together to evolve our thinking and pursue appropriate opportunities accordingly.

Finally, we like the people. As our shareholders well know, we value relationships. As we move further down the path of three separate businesses, we are quite pleased that our first external investor at a non-TCX level, would fit right in with our current investor group in how they see the world, both in terms of business and otherwise.

I feel compelled to note that we took too long for our liking to get this financing done. We know this caused a bit of anxiety with investors and want to both apologize for any worry caused–and acknowledge that we agree. We took the time we did because we were picky in the partner we chose. The deal itself was complicated with both a financing and a partnering component and, over the course of eighteen months, we explored a number of alternative approaches before landing on this one.

In the end, we believe that things worked out just as they should and we look forward to a long and productive relationship and to both building a lot of networks–and hopefully using those networks to truly make the world a better place.

Investors should next expect us to pursue additional debt, supported by this equity, and then find us looking for the next leg of capital to allow Ting Internet to build as much as is profitable and sensible.

We have had lots of conversations with investors in the last sixty days about the economy generally–and specifically about the impact of increased labor costs and interest rates on the profitability of these builds.

The good news is that the coax-to-fiber transition in the US is lucrative enough to continue to support building as much as we can sustain. But, the changing costs do tilt the relative balance between our own builds and partner builds. Our ability to work seamlessly in either construct is a real competitive advantage.

We view the economic future as uncertain. We expect greater shocks, particularly to food and energy over the next couple of quarters. We also continue to believe that demographics and the corresponding challenges to traditional growth metrics are both misunderstood and understated.

We are also not as convinced as others that a reduction in a lot of the consumption that existed historically is a bad thing. We have an economy that still measures consumption as calories with no weighting of the nutrition per calorie.

All of that is to say with uncertainty comes caution, so investors should expect us to move step by step, keeping flexibility and avoiding risks wherever possible.

Across all of our three businesses, we view our marketplaces as quite recession proof, and particularly relative to most of the economy. This puts us in a strong position to take advantage of the opportunities that uncertainty inevitably brings.

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 Tuesday, August 16th, and look for our recorded Q&A audio response and transcript to this call to be posted to the Tucows website on Wednesday, August 31st, at approximately 4 p.m. Eastern time. Thank you.
