Tucows Q1 2023 Management Remarks Transcript

Introduction [Monica Webb, Senior Director, Investor Relations]

Welcome to Tucows' first quarter 2023 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 Monday, May 15th. Management will address your questions directly or in a recorded audio response and transcript that will be posted to the Tucows website on Tuesday, May 30, 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 for full years 2021, 2022 and 2023 year to date—and also includes 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 Monday, May 8th, Tucows issued a news release reporting its financial results for the fourth quarter ended March 31st, 2023. 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]

Opening Remarks

Thanks, Monica.

One small naming convention: I, and many of you, are tired of me using the phrase “ex-Ting.” Going forward, I will refer to the businesses as “Ting” for the Ting business; “Tucows” for the rest of the business, or what I’ve been calling “ex-Ting”; and if I’m referring to Domains or Wavelo specifically, I’ll say “Tucows Domains” or “Wavelo”; and “TCX” for the corporate parent.

The beginning of 2023 has been meaningful for each of our businesses, but particularly for Wavelo and Ting. Wavelo has made impressive progress migrating DISH subscribers on to the platform and is now contributing to adjusted EBITDA. And Ting announced on May 4th that we have completed a debt syndication for $239 million to continue expanding our fiber business. In addition, we made progress on paying down the Tucows debt.

You’ll hear more details about all of those things in today’s remarks and tomorrow at our first Investor Day in Toronto. We’re excited to do a deep dive on each business and its operations and look forward to seeing so many of the owners of the business again. If you’re interested in participating, we do have a livestream link that you can join. Email ir@tucows.com for details.

Now we’ll hear from the heads of each business, 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.

The first quarter for Tucows Domains marked a turning point, post-pandemic, with transactions and domains under management stabilizing. At Investor Day tomorrow, I will talk more about the long-term consistency of our core business as seen through a timeframe before, during and after the pandemic anomaly. But today, I want to highlight what we’ve seen over the last four quarters for our business.

In each successive quarter in 2022, our transactions and domains under management saw declines, which became smaller as the year progressed. Q1 is the first quarter where total transactions increased, albeit ever so slightly, supporting the idea that we’ve worked through the excess demand generated by the pandemic, and we believe we are back to a normalized business trajectory.

The business has performed as expected in Q1, with the exception of the aftermarket for domain sales, which I will speak to in more detail. Revenue for Domain Services for the first quarter at $59.2 million was down 4% from the same quarter of last year, and gross margin at $17.5 million down 11% year over year. Domain Services' adjusted EBITDA was $10.3 million in the first quarter and down 12% from Q1 of last year.

Some notes here: first, the last couple of quarters, we've experienced a weaker aftermarket for domain sales, most notably at the higher end of the price range. And we are actively working with our partner to test adjustments that could drive increased sales. Additionally, there was a one-time large portfolio sale in Q1 2022, and I always like to highlight for investors that these sales are opportunistic and unpredictable.

Next, as most of you know, we recognize revenue and margin monthly over the course of the subscription period, always purchased in yearly increments, with an average term being 13 months. As a result, margin as it correlates to transactions typically lags transaction levels. We're nearing the end of the period where the deferred nature of our revenue and margin, coupled with the stabilizing of transactions, means the business results will trend to flat year over year. We see this now on a billed basis, where margin from our core domain business, both retail and wholesale, is flat year over year, consistent with transactions.

And lastly, we have talked in recent quarters about the impact of the Euro devaluation and the price increases we implemented to address the increased costs of buying in U.S. dollars. The price increases were effective in the latter half of 2022 and will take several quarters as domains are renewed at higher prices, and then the effect flows through the deferral process.

Looking at the channel segments of our business, in our Wholesale channel, revenue for Q1 was down 3% from the first quarter of last year and gross margin down 14%. Within the Wholesale channel, Domain Services' gross margin was down 11% from the same period last year, while Value-Added Services' gross margin was down 21% due to weaker sales in the aftermarket for domain sales.

In our Retail channel, revenue decreased 7%, while gross margin was unchanged year over year—the result of a mix of higher-margin products that offset the decline in revenue.

And our combined overall renewal rate, at 81% in Q1 across all Tucows Domains brands, increased modestly from the previous two quarters and remains well above the industry average.

We're at an interesting point in the business, following the pandemic swings of the last three years and a challenging macroeconomic environment. It's a time that calls for patience, prudence and focus. We'll continue to carefully manage expenses in our domains business, both for efficiency and in support of adjusted EBITDA.

I'm looking forward to talking with many of you tomorrow at our Investor Day where I'll get into more detail on our core business and plans for the future.

Now, over to Justin Reilly, CEO of Wavelo.

Wavelo [Justin Reilly, Chief Executive Officer, Wavelo]

Thanks, Dave.

Wavelo wrapped Q1 with strong performance, in line with our expectations, anchored by a rapid uptick in subscriber migrations. We finished Q1 with 4.2 million total subscribers on the platform, up from 2 million in Q4. As I read this, that number is now north of 6 million. As I mentioned last quarter, we've spent years strengthening our migration muscle and are starting to see that work pay off as we're able to migrate hundreds of thousands of subscribers per week. We continue to expect the majority of the Boost subscribers to migrate by midyear. Miles Davis once said, "Man, sometimes it takes you a long time to sound like yourself." And this business starts to sound like itself as we complete migrations.

Wavelo's revenue was $7.3 million in Q1, an increase of 7% from $6.8 million in Q1 of 2022 and an increase of 63% from $4.5 million in Q4. Beyond the solid growth, I am pleased to see our revenue mix reflecting the predictable, recurring subscriber economics that we've discussed for a few quarters now. Anchored on migrations accelerating, we expect this platform revenue growth to continue to follow suit. Wavelo's gross margin increased proportionally by 7% to $6.3 million this quarter from $5.9 million for Q1 2022.

Adjusted EBITDA for Wavelo was $0.3 million, a decrease of 84% from $2 million in Q1 of 2022 and an increase from negative $1.1 million in Q4. The decrease in adjusted EBITDA compared to Q1 2022 was largely due to two key noncash accounting items: the contra revenue impact from the unwinding contract asset from the DISH agreement and the impact of capitalized labor costs as we continue to invest in our platform.

On the contract asset impact: Q1 revenues of $7.3 million included a $2.2 million contra-revenue impact with the year-over-year impact being negative $4.7 million this quarter, meaning the impact in prior year Q1 2022 was accretive to earnings. As of March 31, 2023, the contract asset balance is $5.3 million, and it will unwind as a contra revenue over the term of the contract, which is up for renewal in Q3 2024.

On capitalized labor costs: We've made meaningful progress over the last year in building the core features of the Wavelo platform. We continue to invest in new features and capabilities and capitalize the associated labor cost with these qualifying capital expenses. Calling your attention back to Elliot's remarks in the Q4 Q&A dialogue in 2022, Wavelo had capitalized labor of $16 million annually. In the current quarter, we've seen lower labor capitalization than we've had in the prior quarter and prior year. This is as expected. As the core platform features harden, the team's focus shifts towards platform maintenance, operational efficiency as we scale subscribers and ramp up on new projects, resulting in lower labor capitalization and higher opex. We expect to capitalize 40%-50% less labor in 2023 than we did in 2022.

I know many of you are interested in our sales pipeline, and I will be talking about it in more detail at our Investor Day tomorrow. While we are seeing strong interest from prospects about switching to the Wavelo platform, they are experiencing increased procurement scrutiny internally on all SaaS purchases, in response to the broader economic environment. This acts as a headwind and naturally elongates sales cycles. We are building a go-to-market machine to respond to this new normal, and I still expect to announce a new customer this year.

We are seeing a wide and global range of providers interested, from ISPs to mobile companies, all with an eye towards reducing inefficiencies in their back office and launching new services more quickly and easily. Cloud transformation, increased competition and a continued dissatisfaction with existing OSS/BSS providers all act as tailwinds for us as we bring much-needed simplicity to our telecom partners.

Thanks for listening, and now over to Elliot.

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

Thanks, Justin.

In Q1, Ting delivered another strong quarter of fiber construction, with total serviceable addresses for Ting-owned infrastructure coming in at nearly 102,000—up 25% year over year—and Partner addresses at almost 20,000—up 16.5% year over year—taking us to over 121,000 total serviceable addresses.

Our Q4 fiber capex was $23.2 million, consistent with the previous three quarters, as we have maintained a steady increased build velocity.

Our total additions for both Ting-owned and Ting Partner serviceable addresses were 5,700, and we expect those numbers to continue to ramp over the next quarter in both Ting-owned footprints, as well as some of our Partner footprints, as new tranches of addresses come online and Q1 seasonal impacts are behind us.

We added 2,200 net subscribers in Q1, taking us over 36,700 in total. Our total subscribers have grown 32% year over year, and we expect that growth will continue as the pre-order pipeline remains strong.

Gross margin grew by 9% quarter over quarter, and 37% year over year, to $7.9 million. Ting's revenue grew 3% quarter over quarter, and 21% year over year, to $11.9 million.

The mature market contribution for Q1 is $1.9 million, up 21% year over year and down 20% from Q4. We see the growth present in mature markets through revenue, which for Q1 is $6.1 million, up 23% year over year and up 2% from Q4.

We all know the difficulties in disclosure with the fiber business. Sadly, this metric is not helping investors. When I went with this disclosure, the hope was to help investors see the profitability in our older cohorts. I underestimated the amount of growth left in the existing footprints. I am loathe to address this before Investor Day tomorrow, and we are already thinking about a more helpful way to do this. I will note that on one level, this is exactly what the syndication does, and we are likely to find the seeds of a solution there.

We continue to make progress in all of our footprints. Of particular note, microtrenching continues in our markets in Alexandria, Virginia, and Centennial, Colorado. Our network in Alexandria was lit with service in March. Our partner market of Colorado Springs is also moving forward, and we're ramping up our marketing efforts there with an expectation of the first serviceable addresses in Q3. Culver City, California, is mostly built out, and we're making progress with the City splicing in our fiber to their backbone, and we'll continue to see large areas become lit with service over the next few months.

A large number of you were able to watch the capex video we released last quarter that provided a deeper explanation of our build and the pace of how capex is spent. If you haven't seen it yet, I highly recommend it—particularly if you are planning to attend the Investor Say as it is a logical departure point for further discussion. You can find it in the Investors section of the website under "Investor Videos."

With the announcement of the syndication last week, the Ting business is ready to move to full execution mode. Primarily over the last five years, and at an increasing pace, we have built a scaled business with over 450 employees, able to efficiently deploy over $100 million in capex per year and able to operate an ISP in numerous markets with perhaps the highest level of customer satisfaction in the country. And we did that primarily with our own internally generated capital. Simply executing from here through the rest of the cycle will likely make this larger than the domains business in revenue and much more profitable.

And now, I'd like to turn the call over to Dave Singh for a deeper dive on our financial results.

Dave?

Financial Results [Dave Singh, Chief Financial Officer]

Thanks, Elliot.

Total revenue for the first quarter of 2023 decreased 0.8% to $80.4 million from $81.1 million for the first quarter of 2022.

Ting had revenue gains of 21% year over year, increasing to $11.9 million in Q1 of 2023 from $9.8 million in Q1 of 2022. Wavelo's revenue also increased 6.6% to $7.3 million in Q1 of 2023 from $6.8 million in Q1 of 2022. The gains were offset by a decline of 3.7% in revenue from Tucows Domains year over year from $61.5 million in Q1 2022 to $59.2 million in Q1 of 2023, mainly due to a lower contribution from expiry aftermarket sales in our Domains business.

There was also a decline in Corporate segment revenues of 30% year over year from $2.9 million in Q1 of 2022 to $2 million in Q1 2023, driven primarily by higher intercompany eliminations.

Gross profit before network costs for the first quarter decreased 1.7% year over year to $31.1 million from $31.7 million, with the decrease due mainly to the lower Domains contribution. As a percentage of revenue, gross profit before network costs this quarter remained flat compared to Q1 of 2022 at 39%.

Breaking down gross profit by business, Tucows Domains' gross profit for the first quarter of 2023 decreased 11% from Q1 of last year to $17.5 million from $19.7 million. As a percentage of revenue, gross margin for Tucows Domains was down slightly at 30% for Q1 of 2023 compared to 32% in Q1 of 2022, mainly a result of weak expiry aftermarket revenues. But also, we're still seeing the impact of the Euro devaluation to the U.S. dollar in 2022, which increased our costs of buying domains in U.S. dollars that were sold to customers in Euros. The price increases we implemented in the later half of 2022 will take a few quarters as names are renewed at higher prices and the effect flows through the deferral process.

Wavelo gross profit increased by 7% to $6.3 million this quarter from $5.9 million for Q1 2022. As a percentage of revenue, gross margin for Wavelo was a healthy 86% this quarter, which is unchanged from Q1 of last year.

Ting gross profit for Q1 increased 37% year over year to $7.9 million from $5.8 million for the same period of last year. As a percentage of revenue, gross margin for Ting was at 66% in the first quarter of 2023, up from 59% in Q1 last year.

Network expenses for Q1 increased 65% to $17.1 million from $10.5 million for the same period of last year. The increase continues to be driven by higher depreciation of our fiber network assets, up 42% year over year. This quarter also included impairment costs related to specific fiber assets, including write-downs of certain fiber capital inventory due to damage and obsolescence.

Total operating expenses for the first quarter of 2023 increased 20% to $31.3 million from $26 million for the same period last year. The increase is primarily the result of the following:

- People costs were up $2.5 million this quarter, with increased workforce costs to support business expansion as well the continued Wavelo ramp.
- Sales and Marketing costs increased by $1.4 million year over year, mainly driven by increased investments in the Ting Internet business expansion.
- Facility and third-party contracting and support costs were up $0.7 million, while stock-based compensation increased $0.8 million year over year, mainly from the subsidiary grants in Ting and Wavelo.
- These were offset by a lower loss on disposition of property and equipment of $0.4 million.

As a percentage of revenue, operating expenses increased to 39% for Q1 of this year from 32% for the same period last year.

We reported a net loss for the first quarter of 2023 of $19.1 million, or a loss of $1.77 per share, compared with net loss of $3 million, or $0.28 per share, for the first quarter of 2022. The loss is the result of the acceleration of the construction of Ting fiber's networks and scaling up of the associated operations; network depreciation and impairment; higher stock-based compensation; and higher interest expenses. Note: Our tax expense reflects our geographic mix, with taxes payable in Canada on our legacy domains business.

Adjusted EBITDA for Q1 was $3 million, down 73% from $11.3 million for Q1 2022. That total breaks down amongst our three businesses as follows:

- Adjusted EBITDA for Tucows Domains was $10.3 million, down 12.2% from Q1 of last year, reflecting the weaker expiry stream aftermarket and an outsized portfolio sale in Q1 2022.
- Adjusted EBITDA for Wavelo was $0.3 million, a decrease of 84% from $2.0 million last year. The decrease is due to the contract asset-related revenue recognition impact related to the reassessment of fixed payments in the DISH agreement. The contract asset and associated revenue recognition varies based on the estimated relative mix of variable and fixed payments. The year-over-year noncash impact of the contract asset change was a negative $2.2 million this quarter versus a positive $2.5 million last year. Adjusting for these, EBITDA actually grew $3 million year over year. As of March 31st, 2023, the contract asset balance is $5.3 million, and it will unwind as a contra revenue over the term of the contract, which is up for renewal in Q3 2024.
- Adjusted EBITDA for Ting was negative $9.3 million compared with negative $4.3 million in Q1 2022 as we continue to invest in our fiber network expansion.
- And finally, the Corporate category had adjusted EBITDA of $1.6 million this quarter, down from $1.8 million in Q1 last year, with the decrease primarily driven by a lower contribution from the legacy mobile base.

Turning to our balance sheet, cash and cash equivalents at the end of Q1 were $11.8 million, compared with $23.5 million at the end of the fourth quarter of 2022 and $6.2 million at the end of the first quarter of 2022.

During the quarter, we had negative $5.3 million in cash from operations compared with a positive $5.4 million in Q1 last year, with the decrease driven by the larger operating investment for Ting Fiber and a timing impact related to Q1 invoicing and subsequent collections of DISH related receivables, which were caught up in April.

We invested $31.7 million in property and equipment, primarily for the accelerated build-out of the Ting Fiber Internet network, in addition to the continued investment in the Wavelo platform. Note: That number reflects the actual cash paid for capital assets in the quarter on our cash flow statement.

Also, we drew a further $30 million in preferred financing under our arrangement with Generate. Post quarter end, we drew another $5 million on the preferred financing but repaid $31 million using the proceeds from the recently announced securitization. A reminder: Cash interest payments are deferred for the first two years.

I also wanted to note that our March 31st, 2023, syndicated loan balance for covenant calculation purposes was a net $232.9 million when factoring in letters of credit and cash on hand of up to $5 million, resulting in a leverage ratio of 4.18 times. We repaid $2.8 million on the facility this quarter and expect to continue quarterly repayments this year.

Finally, deferred revenue at the end of Q1 was $151 million, up 4.3% from $145 million at the end of the fourth quarter of 2022 and down 0.4% from $152 million for the first quarter of last year, primarily reflecting the stabilization of Domains revenues now that the pandemic impacts have normalized.

That concludes my remarks, and I'll now turn it back to Elliot.

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

Thanks, Dave.

I will start with more on the debt syndication we have just completed.

We have borrowed $239 million at an effective interest rate of 8.2% with an implied leverage of 8.5 times contributed markets' run-rate cash flow.

This was a private asset-backed security, or ABS, issuance. A private issuance uses the 4a2 process rather than the public 144a process. We chose the private route due to the size of our issuance and it being faster and less expensive. We also expect to be back in the market for follow-on issuances, and the 4a2 channel will give us an efficient means of doing so.

The lenders in this segment are typically insurance companies looking for good returns with great security. From a lender's perspective, thinking about an ISP customer relative to credit card debt or student debt sounds like a good bet.

The advantage of an ABS process is it most precisely matches the nature of the asset—which has more value with each customer on the network—to the lending capacity.

With financing behind us, we now are able to focus on running the business more efficiently and loading the network more effectively—each of which has positive outcomes for our capital stack.

We will be going into more detail tomorrow on our weighted average cost of capital and the build plan, but I will share some high level ranges here. I had talked for years about how operationally intense this business was, and I said I would be thrilled to deploy $1 billion in capital and could dream of as much as $3 billion. In the end, it looks like I will be closer to thrilled than dreaming.

Through the coax-to-fiber transition, we will likely deploy between $1.25 and $1.75 billion in capital—and that is not just build capex—and will likely reach at least 400,000 homes organically and another 400,000-500,000 homes through partner markets. On Investor Day, we will be taking a deep dive into the atomic unit profitability of both organic and partner homes.

This financing nearly completes the capital stack for our fiber build.

I have noted a number of different times that underpinning our capital strategy was an intention to complete it as late as possible in the cycle. To that end, we have retained Goldman Sachs and Bank Street as part of our broader capital-raising plans to advise us on next steps to set us up for the remainder of the coax-to-fiber transition and beyond.

We are now able to go through that process with a scaled business, a clear build plan and an in-place evergreen financing structure, which we believe puts us in a great position to yield the best result.

Our first ever Investor Day is tomorrow. This will be a bit unique, as we are a unique public company. In the room in Toronto will be over half the float, with over 65% including the livestream. And this is of the total stock outstanding. If we exclude passive and algorithmic holders, and include the employees, friends and family, the number is probably in excess of 90%. This is a unique situation, and we are looking forward to it.

We will of course deal with the three major concerns for investors: the banking facility on the Tucows side; financing for the Ting business; and the profitability of fiber. We will also do a deep dive into each of the three businesses, with leaders from each business sharing their plans and helping you understand their businesses' future.

Our shareholder base has a long tenure and does deeper work than most. Tomorrow is not an opportunity for a new investor to hear the TCX story at a high level; it is an opportunity for the owners of the company to go deep into our plans and to better understand the operating variables, risks and opportunities for our three businesses.

I talked at the end of the Ting section about moving to execution. It is true for Ting, and it is true for Wavelo and Tucows Domains.

Domains is coming off five years of acquisitions and associated platform integrations and is now moving to new opportunities. Wavelo has stood up a new business and has now nearly completed the DISH migration, with over 6 million subs on the platform currently, and is executing against a pipeline and the telecom cloud transformation underway globally.

And Ting, likely the biggest opportunity of them all, can now start to refine and make more efficient—and less costly—all of the new neurons and muscles we have established over the last few years.

Tucows has been pretty good at launching new businesses over the last twenty-five years. We have launched five successful businesses in that time. But we have been excellent at running those businesses efficiently. We are now able to move in all of our businesses—but especially Ting—from a growth phase to an execution phase. And the best thing about that in the Ting context is the execution phase still has so much revenue and EBITDA growth due to the long-lived nature of the asset. All of the operators across three businesses are looking forward to doing what we do best.

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 Monday, May 15th, and look for our recorded Q&A audio response and transcript to this call to be posted to the Tucows website on Tuesday, May 30th, at approximately 4 p.m. Eastern time.

Thank you.
