Tucows Q2 2023 Management Remarks Transcript

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Introduction [Monica Webb, Vice President, Investor Relations]

Welcome to Tucows' second quarter 2023 management commentary. We have prerecorded 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 Thursday, August 10th. 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 22nd, 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 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. Additionally, if you would like to watch segments from our May 9th Investor Day, please email ir@tucows.com with your request.

Now for management's prepared remarks:

On Thursday, August 3rd, Tucows issued a news release reporting its financial results for the second quarter ended June 30th, 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]

Thanks, Monica.

The first half of 2023 has included a number of significant developments for our businesses. Wavelo completed its migration of nearly seven million Boost subscribers for DISH, as well as the migration of Ting to the platform. Ting also completed a securitization for $239 million in May to fund our fiber business. We hosted our first Investor Day in early May as well. We also continued to pay down the Tucows debt in Q2.

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 second quarter for Tucows Domains continued the recent trend of transactions and domains under management returning to a stabilized business trajectory, with seasonal transaction levels comparable year over year, and domains under management stable from last quarter.

Revenue for Domain Services for the second quarter at $60 million was down slightly from $61 million for the same quarter of last year, and gross margin at $17.9 million was down 7% year over year, absent a one-time catch-up accounting adjustment in Q2 2022 which inflated gross margin in that quarter. On a quarter-over-quarter basis, gross margin increased $0.4 million and 2% from Q1. Domain Services' adjusted EBITDA was $10.6 million in the second quarter and down 13% from Q2 of last year.

Some notes here on the reduced gross margin: Half of that impact is from the ongoing weaker aftermarket for domain sales, which I have discussed in recent quarters, and we believe this to be a continuation of a broader, industry-wide challenge reflecting the current macroeconomic environment.

The balance of the impact is split between factors I've also spoken about previously—deferred revenue and price increases working their way through our accounting. These continued to affect our results in Q2, but I don't expect those impacts to be meaningful beyond this quarter.

To put this in context, and as I discussed at our Investor Day in May, our core domain business, excluding both aftermarket and periodic portfolio sales, remains healthy, with billed gross margin consistent year over year in line with transaction levels and expectations.

Looking at the channel segments of our business, in our Wholesale channel, revenue for Q2 was down 2% from the second quarter of last year and gross margin down 9%. Within the Wholesale channel, Domain Services' gross margin was down 5% from the same period last year, while Value-Added Services' gross margin was down 16%. Most of the impact on both revenue and margin are due to weaker sales in the aftermarket for domain sales, which I mentioned earlier.

In our Retail channel, revenue was flat year over year, and gross margin, net the one-time accounting adjustment, was up 2% year over year.

And our combined overall renewal rate, at 79% in Q2 across all Tucows Domains brands, remains within our historical range and well above the industry average.

As I talked about in the last couple of quarters, and shared in more detail on Investor Day, we continue to develop new services to complement our core business and leverage our distribution channels. I look forward to sharing more later this year. But as I mentioned previously, you should not expect to see any contribution to gross margin or impact on operating expenses in 2023. And we'll continue our focus on maintaining margin, including careful management of expenses, in support of adjusted EBITDA.

Now, over to Justin Reilly, CEO of Wavelo.

Wavelo [Justin Reilly, Chief Executive Officer, Wavelo]

Thanks, Dave.

Wavelo wrapped Q2 with its strongest quarter since inception as migrations continued to move at a rapid pace. At its peak, we were migrating subscribers at a volume north of 200,000 per night—the fastest telecom migration in my career and the fastest that anyone we can talk to has seen.

Remember, the two hardest parts of any customer engagement are migrations and network integrations. This is a key milestone that creates the muscle memory we need for future customers. I'm pleased to share that we've finished the migration and closed the quarter with more than 8 million subscribers on the Wavelo platform, nearly doubling where we were at the end of Q1.

Wavelo's revenue was $10.8 million in Q2, an increase of 20% from $9 million in Q2 of 2022 and an increase of 47% from $7.3 million last quarter. Wavelo's gross margin increased by 27% to $10 million this quarter from $7.9 million for Q2 2022.

Adjusted EBITDA for Wavelo was $3.4 million, a decrease of 11.5% from $3.9 million in Q2 of 2022 and an increase from $0.3 million in Q1. The decrease in adjusted EBITDA year over year was largely due to the contra-revenue impact from the unwinding contract asset from the DISH agreement, which, as a reminder, will continue to unwind as contra revenue over the term of the contract which ends in 2024 and then moves month to month. The noncash impact of the contract asset change was a negative $0.7 million this quarter versus a positive $5.6 million in Q2 of last year. Adjusting for these, EBITDA actually grew $5.9 million year over year. To a lesser degree, another impact year over year is that we are capitalizing less labor in 2023 versus 2022, given our major push to build the core features of the platform for DISH has largely concluded and the team is now more focused on platform maintenance and optimizing operations, which results in lower labor capitalization and higher opex.

We're also pleased to report that Ting Internet's website, ordering, provisioning and subscriber management have been migrated to the Wavelo platform. The collaboration with Ting created a robust platform for internet service providers, and we're excited to see the impacts to the Ting operation. You can take a look at the interface for customers at ting.com.

On the pipeline, we are seeing growing interest in the Wavelo platform with new potential logos entering the pipeline each month. This is bolstered by tailwinds from dissatisfaction with existing providers, accelerated cloud transformation and the uptick in infrastructure investment globally. While we entered the market knowing customers were dissatisfied, we hadn't anticipated seeing these levels of dissatisfaction. We're also seeing a consistent theme of OSS/BSS providers' marketing language being far removed from platform realities. Simply saying "cloud-native" into the void does not make it so. Further, we are educating telecoms on the efficiency and long-term value of moving from large professional services' engagements to monthly subscriber fees—something operators have done in other parts of their stack, such as content management or payments, but haven't yet done so at scale here. Cloud transformation globally remains below 10%. While this takes time, the shift is inevitable, and I'm encouraged by our go-to-market team's progress in the first half of the year and pleased with the foundation we are setting as the industry shifts over the coming years. We are both early and right on time.

Thanks for listening, and now over to Elliot.

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

Thanks, Justin.

Ting continued with robust network construction and activation numbers in the second quarter.

Total serviceable addresses for Ting-owned infrastructure came in at 109,300—up 28% year over year—and Partner addresses at 21,100—up almost 16% year over year—taking us to 130,400 total serviceable addresses. With the migration to Wavelo, there is a small restating of serviceable address counts with 839 owned and partner infrastructure addresses removed after reconciling data.

Our fiber capex was down slightly from previous quarters at $21.8 million for Q2. This is not a reflection of the construction completed, where we set records this quarter for network footage, but is due to the mix of construction this quarter being more in lower unit-cost areas.

We added 1,900 net subscribers in Q2, taking us over 38,600 in total. Our total subscribers have grown over 27% year over year, and we expect that growth will continue as we had a large number of serviceable addresses become available late in the quarter with a healthy pre-order pipeline to generate new subscriber installs.

Gross margin grew by 22.0% year over year to $7.1 million. Ting's revenue grew 21% year over year to $12.4 million.

Construction progress continues in both our owned and partner footprints. Our partner market of Colorado Springs is now live with beta customers, with new installs progressing and an official lighting ceremony in mid-August. We will also add small peripheral markets where appropriate to our regional network footprints, which you'll see in increased total potential serviceable addresses for those footprints.

Importantly, there is a lot happening in the partner space. A number of significant pools of capital have now made bold entries. Here I refer to Blackrock with Gigapower; Meridiam, a large French infrastructure investor; and Brookfield with their Intrepid Networks investment; and more. There are, however, very few ISPs like Ting that view operating an ISP as quite separate from building and financing a network.

This imbalance provides opportunity. These infrastructure investors are quite disciplined, so we do not expect this supply/demand imbalance to create "bargains." We do, however, believe that it will present opportunities. We expect this to be an important dynamic in the next phase of the coax-to-fiber transition.

And lastly, we migrated Ting ordering, billing and provisioning, and address and schedule management to the Wavelo platform. In many ways, this is typical of the Tucows playbook of using modern software to elevate the customer experience and to make the lives of both customers—and employees who have to service those customers—better and more efficient. Every element of this new platform will transform our operations, delivering an even more seamless and convenient experience. We invite you to see this in action on our website at ting.com.

We continue to build well, load the network well and to improve operations. As we look around us, we are starting to see others sweat a bit with the challenges of building a network and operating an ISP. We are clearly now into the execution period of this industry, which is just where we like to be.

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

Financial Results [Dave Singh, Chief Financial Officer]

Thanks, Elliot.

Total revenue for the second quarter of 2023 increased 2.3% to $85 million from $83.1 million for the second quarter of 2022.

Ting had revenue gains of 21% year over year, increasing to $12.4 million in Q2 of 2023 from $10.2 million in Q2 of 2022. Wavelo's revenues also increased 20% to $10.8 million in Q2 of 2023 from $9 million in Q2 of 2022. The gains were offset by a decline of 2% in revenue from Tucows Domains year over year from $61 million in Q2 2022 to $60 million in Q2 of 2023, mainly due to a lower contribution from expiry aftermarket sales.

There was also a decline in Corporate segment revenues of 34% year over year from $2.8 million in Q2 of 2022 to $1.9 million in Q2 2023, driven primarily by lower revenues from legacy mobile subscribers and higher intercompany eliminations.

Gross profit before network costs for the second quarter increased 1.2% year over year to $34.2 million from $33.8 million. As a percentage of revenue, gross profit before network costs this quarter remained flat compared to prior year at 40%.

Breaking down gross profit by business, Tucows Domains' gross profit for the second quarter of 2023 decreased 10.2% from Q2 of last year to $17.9 million from $20 million. As a percentage of revenue, gross margin for Tucows Domains was down to 30% for Q2 of 2023 compared to 33% in Q2 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 the higher prices and the effect flows through the deferral process.

Wavelo's gross profit increased by 27% to $10 million this quarter from $7.9 million for Q2 2022. As a percentage of revenue, gross margin for Wavelo was a robust 93.5% this quarter, which is up from 88.2% in Q2 of last year.

Ting gross profit for Q2 increased 22% year over year to $7.1 million from $5.8 million for the same period of last year. As a percentage of revenue, gross margin for Ting was at 57% in the second quarter of 2023, unchanged from Q2 of last year.

Network expenses for Q2 increased 38% to $16.2 million from $11.7 million for the same period of last year. The increase continues to be driven by higher depreciation of our expanding fiber network assets, up 33% year over year.

Total operating expenses for the second quarter of 2023 increased 17.5% to $31.1 million from $26.5 million for the same period last year. The increase is primarily the result of the following:

- People costs were up $3.2 million, with increased workforce costs to support business expansion related to the growth of Ting and Wavelo.
- Sales and Marketing expenses increased by $0.8 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 $0.2 million, while stock-based compensation increased $0.6 million year over year, mainly from the subsidiary grants in Ting and Wavelo.
- And finally, loss on disposition of property and equipment and amortization of intangible assets are down $0.3 million from Q2 2022.

As a percentage of revenue, operating expenses increased to 37% for Q2 of this year from 32% for the same period last year.

We reported a net loss for the second quarter of 2023 of $31.0 million, or a loss of $2.86 per share, compared with net loss of $3.0 million, or $0.29 per share, for the second quarter of 2022. We had a nonrecurring accretion of redeemable preferred shares and an associated one-time loss of $14.7 million on debt extinguishment resulting from the early redemption of a portion of Generate's preferred shares. The remainder of the net loss is the result of the acceleration of the construction of Ting's fiber networks and scaling up of the associated operations; network depreciation; 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 Q2 was $5.4 million, down 54% from $11.7 million for Q2 2022. That total breaks down amongst our three businesses as follows:

- Adjusted EBITDA for Tucows Domains was $10.6 million, down 12.6% from Q2 of last year, reflecting the weaker expiry stream aftermarket.
- Adjusted EBITDA for Wavelo was $3.4 million, a decrease of 11.5% from $3.9 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 of 2022 and 2021. The decrease in adjusted EBITDA is primarily due to the contract asset-related revenue recognition impact related to the reassessment of fixed payments in the DISH agreement. As a reminder, the contract asset and associated revenue recognition varies based on the estimated relative mix of variable and fixed payments. The noncash impact of the contract asset change was a negative $0.7 million this quarter versus a positive $5.6 million last year. Adjusting for these, EBITDA actually grew $5.9 million year over year. As of June 30th, 2023, the contract asset balance is $4.6 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 $10.3 million, compared with negative $6.2 million in Q2 2022 as we continue to accelerate our fiber network expansion.
- And finally, the Corporate category had adjusted EBITDA of $1.7 million this quarter, down from $1.9 million in Q2 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 Q2 were $147.9 million, compared with $11.8 million at the end of the first quarter of 2023 and $6.5 million at the end of the second quarter of 2022. In addition to the $147.9 million, we have $11.7 classified as restricted cash as part of the asset-backed securities—or ABS—transaction this quarter. Of the $11.7 million, $8.4 million will sit in a trust account for the duration of the ABS notes. The remaining $3.3 million reflect the cash collections from the securitized assets and get distributed monthly as interest to the noteholders, fees to third-parties and then with the remaining funds coming back to Ting.

During the quarter, we had negative $1.6 million in cash from operations, compared with positive $12.6 million in Q2 last year with the decrease driven by the larger operating investment for Ting Fiber.

We invested $23.2 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.

As mentioned earlier, we issued our first-ever set of asset-backed securities this quarter for the Ting business. The notes were issued with a value of $238.5 million with net proceeds of $220.5 million after taking into account the OID, or original issue discount, and issuance costs. The notes carry a blended coupon rate of 6.88%, and after taking into the OID, an effective rate of 8.2%. The notes are secured against most of the fiber assets, including certain customer relationships, of Ting. Interest of approximately $1.4 million is paid monthly, with monthly covenant tests of annualized revenue versus interest expense.

In Q2, we drew another $5 million on the preferred financing, but after receiving the proceeds from the Ting securitization in early May, we repaid $31 million in the preferred financing which resulted in a loss of $14.7 million on the early debt extinguishment. A reminder: Cash interest payments on the preferred debt are deferred for the first two years.

I also wanted to note that our June 30th, 2023 syndicated loan balance for covenant calculation purposes was a net $224.3 million when factoring in letters of credit and cash on hand of up to $5 million, resulting in a leverage ratio of 4.17 times. We repaid $7 million on the facility this quarter and expect to continue quarterly repayments this year.

Finally, deferred revenue at the end of Q2 was $151 million, unchanged from the first quarter of 2023 and up slightly from $150.1 million for the second quarter of last year, primarily reflecting the stabilization of Domains revenue 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.

To start, now halfway through the year, I would like to reiterate our consolidated adjusted EBITDA guidance of $14 to $16 million. It looks like Tucows Domains will be a little light due to weakness in the secondary market and Wavelo will be a bit stronger due to effective cost control.

Last quarter, I talked about our successful ABS process and the importance of us having sourced the vast majority of the capital necessary for this cycle. I also shared that we had retained Goldman Sachs and Bank Street to explore further opportunities for our capital structure. That investigation led to us maintaining the status quo for now. The opportunities available were more structured than we were looking for. We are happily in a position of strength and will instead focus on execution.

We are certainly informed by our view that we are operating in a unique macro environment, one with huge opportunities and significant risks. This is a good time to focus on execution and be conservative.

We are also informed by what we described earlier—a number of larger partner markets needing tenants—which do not require the massive capital that organic markets do. For clarity, I am not signaling a massive change in our approach or our strategy; rather, I'm identifying some current market opportunities that our strategy might allow us to take advantage of.

For TCX, our three businesses are all in a better place than just a year ago. Domains continues to generate cash as it always has, with progress on some upside opportunities. Wavelo has moved to now solidly generating cash, and we only expect that trend to continue. Importantly, Ting is now at or near the low point of loss on an operating basis, and we can start to grind towards operating cash-flow positive.

At its simplest, we have gone from Domains having to generate cash sufficient to invest in two businesses—one of which is extremely capital intensive—to those two businesses becoming cash-flow positive in one case and self-funded in the other. This means deleveraging. It means executing.

We also believe there is a fair bit of dislocation in financial markets right now. This is true in both public and private markets as assets start to revalue following the end of free money and the unwinding of a number of structural elements of the last decade plus. We are glad to be where we are this year while this takes place, rather than where we were a year ago.

What I say next applies to all three of our businesses. It is important, while focusing on execution, that we do not lose sight of the big picture. All of the massive opportunities—whether they be in AI or otherwise—and many of the challenges make technology both more important and more complex for people. Our businesses need to understand how they can help people take advantage of these massive opportunities and help them navigate the challenges that the increasing role of technology brings—directly, as in the case of Ting, or through partners in the case of Tucows Domains or Wavelo.

We are at an interesting time. There is so much technological change, and in most respects, people do not have a trusted partner to help them make the most of it. Technology in 2023 is like health or happiness; it is fundamental to our existence, and we are often left without knowing where to turn to be supported.

That role—the role that used to be fulfilled in the early internet by dial-up ISPs—has most certainly not been taken up by incumbent telecom. The incumbents are simply not in relationship with their customers. They are not trusted nor liked. Many of Tucows Domains customers are. Ting is. Wavelo gives incumbents a chance to be.

We all thought the change ushered in by technology in the last couple of decades was massive. We are only at the beginning. And all of the TCX businesses are right in the middle of that change.

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 Thursday, August 10th, and look for our recorded Q&A audio response and transcript to this call to be posted to the Tucows website on Tuesday, August 22nd, at approximately 4 p.m. Eastern time.

Thank you.
