Tucows Q3 2023 Management Remarks Transcript

Introduction [Monica Webb, Vice President, Investor Relations]

Welcome to Tucows' third 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, November 9th. Management will either address your questions directly or provide a recorded audio response and transcript that will be posted to the Tucows website on Tuesday, November 21st, 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 seven 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 Thursday, November 2nd, Tucows issued a news release reporting its financial results for the third quarter ended September 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 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 to 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, Tucows]

Introduction

Thanks, Monica.

Our third quarter results show continued strong growth of Wavelo and Ting and a steady state for Tucows Domains. We recently signed a new credit agreement for the Tucows syndicated debt that gave us improved terms and further stability. We have also repaid a net of $6.5 million on the balance on that debt this quarter using the cash flow from Wavelo and Tucows Domains.

As we head into Q4, we are on track for our 2023 guidance with EBITDA on the TCX side of $55 to $60 million and with an EBITDA loss on the Ting side of $42 to $45 million.

This is all happening in a unique economic context where markets, both public and private, are continuing to reshape after 15 years of cheap capital.

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.

We continue to return to a normalized business trajectory in 2023. Q3 transactions are up 3%, and domains under management are up slightly year over year. We continue to focus on managing the business for margin. Concurrently, we continue to develop new services to complement our core business and leverage our distribution channels. I'll take a moment now to talk about the business in more detail.

Revenue for Domain Services for the third quarter was $61.1 million, up 1% from $60.3 million for the same quarter last year. And our gross margin was $18.4 million, also up 1% year over year. When you look at a quarter-over-quarter basis, our gross margin increased $0.4 million, or 2.5%, in Q3. This increase is an important indicator of the health of the business. In previous quarters, we reported our gross margin was declining. It is now flat to increasing due to deferred revenue and price increases working their way through our accounting. The same items are positively impacting Domain Services' adjusted EBITDA, which was $10.9 million in the third quarter, up 5% from Q3 of last year.

Now let's look across the segments of our business. In our Wholesale channel, revenue for Q3 was unchanged compared to Q3 of last year, and gross margin is down 4% year over year. Domain Services' gross margin remained flat compared to the same period last year, while Value-Added Services' gross margin was down 13%. This is due to weaker sales in the domains aftermarket, which continues to be an issue industry wide.

In our Retail channel, revenue was up 9%, and gross margin was up 17% year over year. A key driver of the outsized retail margin was the sale of a few high-value domain names, which will happen over the course of a year. Net of these sales, gross margin was up 2%.

Our combined overall renewal rate, at 78% in Q3 across all Tucows Domains brands, remains within our historical range and well above the industry average.

And finally, within our Registry Services business, which we acquired in Q4 2021, we recently completed the migration of two new clients onto our platform: .my, the country code top-level domain for Malaysia, and .cloud, a generic top-level domain launched in the last round of new gTLDs. This is an encouraging step forward as we look to grow our Registry Services business.

Now turning to our new value added services. In recent quarters, I have referenced that we have been quietly exploring a few product ideas that would complement our core business and leverage our distribution channels. At Investor Day earlier this year, I discussed our history and the challenges with adding new services. I also emphasized that we are conducting this work within our current highly efficient cost structure, which continues to benefit from the platform work that we have done.

The first area of focus for us is modernizing web hosting for small resellers. While the largest hosting companies long ago transitioned to the cloud, we have tens of thousands of resellers who still operate their businesses using technology between 10 and 20 years old.

Since 2015, we have operated a small hosting company within Tucows, which is representative of a typical reseller and allows us to gain hands-on experience working with the older technologies resellers use. This experience has given us insight into both where the benefits are available and to the difficulties of modernizing. We have developed a set of automation tools that enable resellers to transition to cloud-based services. Additionally, we have enrolled a number of resellers into an early-adopter program focused on improving the user experience. More work still remains before an official launch next year, but we have been pleasantly surprised by both the level of interest and engagement in this area.

The other product area we are focusing on is creating a new billing and provisioning experience that our resellers can extend to their customers for easier domain purchasing and

management. We will continue to iterate and extend the functionality of this service as billing and provisioning is something Tucows has consistently excelled at in domain names, mobile and fixed internet. There is both a need and an interest for this type of product offering in our channel, so we are optimistic about its adoption.

We're very excited about the direction we are moving in, and it seems our channel is as well. As a mature business in a competitive space, being able to add a complementary revenue stream and new products is important to maintain revenue growth. As I have mentioned previously, the initial contribution to gross margin and the impact on operating expenses will be quite modest with an expectation that we can scale the new offerings over the coming years. I will continue to keep investors updated on our progress in this area as it evolves.

Now, over to Justin Reilly, CEO of Wavelo.

Wavelo [Justin Reilly, Chief Executive Officer, Wavelo]

Thanks, Dave.

In Q3, we delivered another strong quarter in revenue and gross margin and our strongest quarter of Adjusted EBITDA since Wavelo's launch. Wavelo's revenue was $11.1 million in Q3, an increase of 174% from $4 million in Q3 of 2022 and an increase of 3% from $10.8 million last quarter. Wavelo's gross margin increased by 176% to $10.5 million this quarter from $3.8 million for Q3 of 2022 and 4% from $10.1 million last quarter. As we've previously noted, we experience outsized revenue recognition annually in Q2 related to bundled professional services included as part of the platform services provided to DISH as well as the contra-revenue impact from the unwinding contract asset from the DISH agreement. Adjusting from these lumpy and non-cash impacts, revenue and gross margin actually grew $0.9 million and $1.1 million, respectively, quarter over quarter.

Adjusted EBITDA for Wavelo was $4.2 million, way up from a loss of $0.9 million in Q3 of 2022 and an increase of nearly 24% from $3.4 million in Q2. This marks the first quarter with a fully-loaded Boost base on the Wavelo platform. We are seven quarters into operating Wavelo as a standalone business, and I'm pleased with our management team's discipline and ability to manage costs while onboarding millions of subscribers. When we launched Wavelo inside of TCX — a public company known for conservative operations and cash generation — there was concern expressed that not taking a traditional VC-funded route would hold Wavelo back. Now this choice looks prescient as early-stage VC has dried up and disciplined operations are what everyone aspires to.

On DISH, we are encouraged by their progress in retail wireless and on their 5G network. They now have the most competitive unlimited and iPhone offers in the market with Boost Infinite as

well as the largest commercial deployment of 5G voice, reaching more than 100 million Americans in over 60 markets. While we are excited, there is not yet a clear indication that DISH is in a position to throw massive advertising dollars at this; and we all know in telecom, and in mobile in particular, that some of the CAC spend we see is outrageous. We can say that DISH not only has the best and most transparent offer in the market, but we also feel good about the fact that this continues to demonstrate that they appreciate what telecom can be — and are not constrained by what it has been.

As we shared last quarter, Ting is now operating its business on Wavelo's platform. We are in the midst of customer migrations and helping Ting launch new features to continue delighting the happiest ISP customers in the United States.

On new customer growth, Q3 was our strongest quarter to date in adding new qualified opportunities to the pipeline. This is a mix of net new logos as well as cloud upgrades from our legacy Platypus business. The latter is the result of a pilot program we launched earlier this year, and given early traction, we expect to expand in 2024. Both are strong indicators of cloud transformation accelerating and telecoms looking for a change to more customer-centric software. This momentum is the positive result of standing up a dedicated go-to-market team in Q1 of this year.

I am happy with where the pipeline is today. But what is also true, in general, is that SaaS purchase decisions are sitting longer in the pipeline than they have in the past. When it comes to telecom and provisioning, that is even more true. If providers are going to replace provisioning, it's going to take both time and investment, and if a business is in cost-cutting mode, as many are right now, it becomes less of a priority versus quick operating wins.

Our competitors spend a large percentage of their revenue each year on sales and marketing. While we view much of this spend as inefficient, we do expect to invest further over the next few quarters to grow the pipeline, while staying well below the industry average for go-to-market spend.

Thanks for listening, and now over to Elliot.

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

Thanks, Justin.

Total serviceable addresses for Ting-owned infrastructure came in at 114,500 — up 28% year over year — and Partner addresses at 25,400 — up almost 36% year over year — taking us to 139,900 total serviceable addresses. I'm particularly pleased to see addresses in Colorado Springs starting to become available.

Our fiber CapEx was down from previous quarters at $17.3 million for Q3. This is primarily because we are transitioning to a new microtrenching vendor in Alexandria, leading to a small gap in construction while we onboard the new vendor. We resumed construction there in Q4.

Q3 was our best quarter for new subscribers over the last seven quarters. We added 2,600 net subscribers in Q3, taking us over 41,000 in total. Our total subscribers have grown over 26% year over year, and we expect that growth to continue as our construction steadily progresses and we continue to have a strong pre-order pipeline for installations.

Our gross margin grew by 20% year over year to $8.0 million, and revenue grew 17% year over year to $12.9 million.

We have shared in the past that capital was flowing into the "landlord" side of partner markets. There has not been a similar growth in tenants. We are the most experienced "tenant" in the industry, having partnered with cities, utilities and multiple commercial providers. As the partner segment matures, we are seeing more and more partnership opportunities but are taking a more pragmatic approach to sharing risks and expectations of partner build performance. As you know, what's attractive about partnerships — given the right terms — is that they allow us to leverage our greatest strength, operating the best ISP in the country, without shouldering the capital requirements and complexities of building in those markets.

Investors may have seen the announcement yesterday of our partnerships with Blue Suede Networks and Vibranium Network in Memphis, Tennessee. This will be Ting's largest partner market to date that will serve up to 315,000 addresses with Ting operating as the exclusive residential and small business ISP for the first five years. The first customers will come online in the summer of 2024 with ongoing network construction projected through 2030.

We're also taking a new and novel approach to customer acquisition in Memphis. To lead its marketing and adoption strategy in Memphis, Ting will be partnering with Vibranium Network, a dedicated team of marketers and entrepreneurs who specialize in using cultural influence to create business impact and build wealth in African American communities.

Leveraging insights from our existing partner markets, Ting has created a structure that allows the partnership with Blue Suede Networks to better share the build risk across our two businesses. This allows the market to be more cash-flow friendly in the short term while we're investing in marketing and installs.

We also recently expanded our Tucson, Arizona, footprint by adding 25,500 potential serviceable addresses in Marana, just north of Tucson. You will recall that our strategy with the

acquisition of SimplyBits was to leverage their operation to expand more easily into Pima County, and Marana is the first of our organic builds in the area.

The last item is some costs in this quarter's opex associated with exploring the sale of a minority equity stake in Ting with Goldman Sachs and Bank Street. This ultimately didn't come to fruition. The opportunities available to us were more structured than we were looking for, and we opted to hold off for the time being. However, the transaction expenses land in the quarter.

The Ting business continues to show strong results while we concurrently focus on effectively scaling the business as we grow into larger and more diverse markets.

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 third quarter of 2023 increased 11.4% to $87 million compared to $78.1 million for the third quarter of 2022.

When looking across the different businesses, Ting had revenue gains of 17.4% year over year, increasing to $12.9 million in Q3 2023 from $10.9 million in Q3 2022. Wavelo's revenue increased 174% to $11.1 million in Q3 2023 from $4 million in Q3 2022. And the revenue for Tucows Domains for Q3 was up 1.3%, increasing to $61.1 million from $60.3 million in Q3 2022.

The gains from the three businesses were offset by a decline in Corporate segment revenues of 30% year over year, from $2.8 million in Q3 2022 to $2 million in Q3 2023. The decline was primarily driven by lower revenues from legacy mobile subscribers retained in the sale of Ting Mobile subscribers to DISH as well as higher intercompany eliminations.

Gross profit before network costs for the third quarter increased 22% year over year to $36.3 million from $29.6 million in Q3 2022. As a percentage of revenue, gross profit before network costs this quarter was 42% compared to 38% for Q3 2022.

Breaking down gross profit by business, Tucows Domains' gross profit for the third quarter of 2023 increased 1.1% from Q3 of last year to $18.4 million from $18.2 million. As a percentage of revenue, gross margin for Tucows Domains remained unchanged year over year at 30% for Q3 2023.

Wavelo's gross profit increased by a robust 176% to $10.5 million this quarter from $3.8 million for Q3 2022 as Wavelo finished the quarter with fully loaded Boost subscribers. As a percentage of revenue, gross margin for Wavelo was 95% this quarter, which is up slightly from 94% in Q3 of last year.

Ting gross profit for Q3 increased 20% year over year to $8 million from $6.7 million for the same period of last year. As a percentage of revenue, gross margin for Ting was 62% in the third quarter of 2023, up slightly from 61% in Q3 of last year.

Network expenses for Q3 increased 66% to $19.5 million from $11.8 million for the same period last year. This increase continues to be driven primarily by higher depreciation of our expanding fiber network assets, up 28% year over year, as well as people costs of managing our expanding network. This quarter also included impairment costs related to write-downs of certain Fiber capital assets due to damage and obsolescence.

Total operating expenses for the third quarter of 2023 increased 24% to $33.9 million from $27.4 million for the same period last year. The increase is primarily the result of the following:

- People costs were up $1.6 million, with increased workforce costs to support business expansion related to the growth of Ting and Wavelo.
- Sales and Marketing costs increased by $0.8 million year over year, mainly driven by increased investments in the Ting Internet business expansion.
- Facility, travel and third-party contracting and support costs were up $1.5 million while professional fees were up $0.9 million, primarily related to the Ting equity raise process Elliot referenced earlier. Stock-based compensation increased $0.7 million year over year mainly from the subsidiary grants in Ting and Wavelo.
- Foreign exchange impacts increased expenses by $0.1 million this quarter, primarily driven by the year-over-year impacts from the revaluation of our of foreign-denominated monetary assets and liabilities.
- And finally, loss on disposition of property and equipment and amortization of intangible assets are down $0.2 million from Q3 2022.

As a percentage of revenue, operating expenses increased to 39% for Q3 of this year from 35% for the same period last year.

We reported a net loss for the third quarter of 2023 of $22.8 million, or a loss of $2.09 per share, compared with a net loss of $8 million, or $0.74 per share, for the third quarter of 2022. The net loss is primarily the result of the ongoing construction of Ting's fiber networks and scaling up of the associated operations; higher network depreciation and an impairment of property and equipment; higher stock-based compensation; and higher interest expenses from

both higher interest rates and increased debt. Please note that our tax expense reflects our geographic mix, with taxes payable in Canada on our legacy domains business.

Adjusted EBITDA for Q3 was $4.5 million, down 43% from $7.9 million for Q3 2022. That total breaks down amongst our three businesses as follows:

- Adjusted EBITDA for Tucows Domains was $10.9 million, up 5.1% from Q3 of last year.
- Adjusted EBITDA for Wavelo was $4.2 million, an increase of nearly 600% from a loss of $0.9 million last year.
- Adjusted EBITDA for Ting was negative $12.2 million compared with negative $5.0 million in Q3 2022, as we continue to invest in our fiber network expansion.
- And finally, the Corporate category had adjusted EBITDA of $1.5 million this quarter, down from $3.4 million in Q3 last year. The decrease is primarily driven by a lower contribution from the legacy mobile base and higher intercompany eliminations.

Turning to our balance sheet, cash and cash equivalents at the end of Q3 were $110.7 million, compared with $147.9 million at the end of the second quarter of 2023 and $30.5 million at the end of the third quarter of 2022. In addition to the $110.7 million, we have $11.7 million classified as restricted cash as part of the asset-backed securities — or ABS — transaction last quarter. As a reminder, of the $11.7 million of restricted cash, $8.5 million will sit in a trust account for the duration of the ABS notes. The remaining $3.1 million reflects the cash collections from the securitized assets and is distributed monthly as interest to the noteholders, fees to third-parties and with the remaining funds coming back to Ting. I will also note that we generated $3.0 million in interest income this quarter.

During the quarter, we had negative $7.1 million in cash from operations compared with negative $1 million in Q3 last year, with the increase driven primarily by the larger operating investment for Ting Fiber.

We invested $22.6 million in property and equipment, primarily for the continued build-out of the Ting Fiber network, in addition to the continued investment in the Wavelo platform. Note that this number reflects the actual cash paid for capital assets in the quarter on our cash flow statement and includes capitalized interest.

As mentioned last quarter, we issued our first ever set of asset-backed securities in May for the Ting business. As a reminder, the notes were issued with a value of $238.5 million with net proceeds of $220.5 million after taking into account the issuance costs and original issue discount. The notes carry a blended coupon rate of 6.88% and, after taking into account the original issue discount, 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.

I also wanted to advise that our September 30, 2023, syndicated loan balance for covenant calculation purposes was a net $218.5 million when factoring in letters of credit and cash on hand of up to $7.5 million, which resulted in a leverage ratio of 3.77 times. We repaid a net $6.5 million on the balance of the loan this quarter and expect quarterly payments to continue. We have already repaid a further $1.4 million in early Q4.

Finally, deferred revenue at the end of Q3 was $150 million, down from $151 million for the second quarter of 2023 but up from $147 million for the third quarter of last year. This is primarily due to 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.

This quarter again held positive trends for all three of our businesses.

In Domains, we see continued progress towards both platform operating efficiencies and perhaps the most exciting new service launches since Ting.

In Wavelo, we have successfully migrated the bulk of the Ting ISP customers, integrated most of the third-party applications and made material progress on the new customer pipeline — all while operating cash-flow positive.

In Ting, we are seeing the flexibility of our ISP operations manifest in more and better partner opportunities. Partner opportunities tended to have negative operating cash flow for the first couple of years as we load the network and need to spend dollars on marketing and installs. We are now more able to structure these deals so that they are neutral or even cash-flow positive very quickly.

The macroeconomic environment has not improved over the last 90 days but has instead been reinforced. We continue to see further evidence that huge asset classes, private equity, venture capital and commercial real estate all need to be repriced. We are starting to see the first vestiges now as seed venture capital has dried up and private equity is starting to triage. This repricing will take years.

The macro economy also weighs on the stock market for obvious reasons. This has exacerbated the gap between public and private valuations. It was large and is now even greater. And I expect this gap to continue for years as those overvalued asset classes reprice. This means that the traditional off ramp for venture capital and private equity investments is much less available than it has been for the last 20 years.

TCX has a tight cap table and thin public float, making the disconnect between the value of our three businesses and the TCX stock price the greatest I have seen in my time running a public company – Even greater than before we announced our first Dutch tender in 2008.

The greater the discrepancy between the value of the three businesses and the stock price, the greater our desire to get to cash wherever possible.

I note that while we are conservative in our view of the macro economy, we also note that there is still lots of capital looking to be deployed. We also believe that capital will need to prioritize businesses that have strong cash flows and that are generally recession proof.

That description applies to all three of our businesses.

There are two other specific trends in fiber particularly to discuss — the move to asset-backed securities (ABS) and the trend towards taking the benefit of a fiber build out of the public market and into private hands.

With ABS, we are seeing companies like Altice push hard to follow the ABS trail that Metronet and Ting created and try to strengthen their capital structure — and I always say this with a big hat tip to Metronet. This may become the preferred method of recapping private equity investments that need further funding. We may also see subscale private equity investments combining in order to reach the scale necessary to put an ABS in place.

An ABS facility provides both a lower cost of capital and more leverage. They require scale and an appropriate level of operational efficiency. This makes any subsequent capital infusion easier. Our existing ABS facility is a real advantage as we move forward.

The second trend is the privatization of the economic returns of a fiber build. We have seen that twice this quarter: an activist shareholder with an existing telecom backer taking a stake in Frontier as well as the privatization of Consolidated Communications.

In each case, the thesis is that the public market will not allow a company to go through the cash burn of a fiber cycle. In each case, the company needs capital to fully take advantage of the opportunity in front of them. In each case, the public market has not been terribly receptive.

Most importantly, in each case, there is smart money involved, and in the case of Consolidated, that smart money is extremely familiar with the space. The group that is taking Consolidated private is Searchlight Capital. Searchlight is perhaps the most active private investor in the coax-to-fiber transition in the U.S., with investments in Ziply, Uniti/Windstream, All Points Broadband and a pre-existing investment in Consolidated from which they launched the current process.

We have met with them. They are smart and know the space as well as or better than anyone. And those that know me know I do not say that lightly.

There are important takeaways for TCX investors from these two situations. First, TCX investors are on the right side of the trade. They are on the same side of the trade as Searchlight, BCIP, Jana and Jana's unnamed telecom partner.

Second, private capital values owning fiber assets — the long term opportunity is clearly seen by investors like Searchlight. TCX provides one of the very few public vehicles that let investors participate in that trade.

In closing, in 22 years running a public company, I have never spent more of my time on capital allocation. These are dynamic times, and as I said last quarter, we have a demonstrated ability to take advantage of them.

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, November 9th, and look for our recorded Q&A audio response and transcript to this call to be posted to the Tucows website on Tuesday, November 21st, at approximately 4 p.m. Eastern time.

Thank you.

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