Cogent Communications Holdings, Inc. NasdaqGS:CCOI

Earnings Call

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Presentation

Operator

Good morning, and welcome to the Cogent Communications Holdings First Quarter 2023 Earnings Conference Call. [Operator Instructions] As a reminder, this conference call is being recorded, and it will be available for replay at www.cogentco.com. A transcript of this conference call will be posted at Cogent's website when it becomes available. Cogent's summary of financial and operational results attached to its press release can be downloaded from the Cogent website.

I would now like to turn the call over to Mr. Dave Schaeffer, Chairman and Chief Executive Officer of Cogent Communications Holdings.

David Schaeffer
Founder, Chairman, CEO & President

Hey, good morning, and thank you, and welcome to all on our first quarter 2023 earnings conference call. I'm Dave Schaeffer, Cogent's CEO. With me on this morning's call is Thad Weed, our Chief Financial Officer. Hopefully, you've had a chance to review our earnings press release. Our press release includes a number of historical quarterly metrics that we present on a consistent basis each quarter.

Now for an overview of our results. Our revenue for the quarter increased sequentially by 1.1% to $153.6 million and increased 3% year-over-year. On a constant currency basis, our revenue for the quarter year-over-year grew by 4%. Our corporate business continues to be influenced by real estate activity in the central business districts of major cities. 2 key statistics, including the level of security badge entries into a building and leasing activities indicate that year-to-date, the real estate market and leasing activity in these central business districts has continued to see improvement, but has not yet returned to pre-pandemic levels.

We continue to remain cautious in our outlook for our corporate revenues given the uncertain economic environment and other challenges that are a result of the after effects of the pandemic. Our NetCentric business continues to benefit from continued growth in video, traffic and streaming. For the quarter, our traffic was up sequentially 3% quarter-over-quarter and increased 20% on a year-over-year basis. On a U.S. GAAP basis, our NetCentric revenues grew sequentially by 2.7% and grew by 7.8% year-over-year. However, adjusting for currency fluctuations, on a constant currency basis, our NetCentric revenues increased by 10.2% from the first quarter of 2022.

Our sales force productivity increased from 3.8 orders installed per month per full-time equivalent last quarter to 4 units per month per full-time equivalent sales person. We also increased the number of sales reps in this quarter by 14 or a 2.6% sequential increase. We ended the quarter with 562 sales reps and 539 full-time equivalent sales reps. This represents a sequential increase of 7.2% of full-time equivalent sales reps from the fourth quarter of 2022 to the first quarter of 2023.

Now for some overviews on our recently announced closure of the acquisition of the Sprint Global Markets Group business or T-Mobile's Wireline business. We closed that transaction on May 1st, ahead of our initially planned closing. We incurred approximately $400,000 in professional fees in the first quarter and have spent a cumulative expense of about $2.6 million in professional fees associated with the closing of this transaction.

The Sprint Wireline revenues were approximately $570 million annually for the fiscal year 2022. The Sprint Wireline revenue run rate at closing is approximately $490 million. We expect this number to decline and exit the year at year end with a run rate of the acquired customer base of $440 million, which we then expect to remain stable. The primary reason for this reduction in revenue is the continued elimination of non-core products. We expect that number of products will be reduced from approximately 30 products that were offered when our agreement was signed down to 4 core products at year end.

Over the next 3 years, we expect to achieve significant annual savings due to the synergies of the combination of these businesses. We expect that $180 million will be saved on the North American

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network of Sprint, primarily through the use of our on-net footprint and the elimination of off-net services. Internationally, we will be shutting down the existing Sprint network and migrating all of that traffic on to the owned Cogent network as opposed to the leased Sprint network, resulting in about $25 million in annualized savings.

And then finally, we will be able to exit a significant IRU in North America that will save Cogent approximately $15 million annually in operation and maintenance expense for that network when our next anniversary that allows us to exit occurs within the next couple of years. We anticipate achieving additional synergies through SG&A savings and other cost reductions as well as positive revenue synergies.

On the closing date, we paid $1 to the seller and we funded $61.1 million in cash for working capital as set forth in the purchase agreement. This working capital payment was primarily related to the injection of approximately $43.4 million in approximately 30 international subsidiaries to have sufficient liquidity in these facilities to continue operations as we migrate those customers, those vendors and those employees on to the Cogent international entities. Additionally, the working capital adjustment includes an estimated payment of approximately $31 million that we will receive from T-Mobile for acquired lease obligations. These will be paid in 4 equal 25% installments in months 55 through 58 post-closing.

Now for a little overview of our product expansion. In connection with the acquisition of the wireline business, we are beginning to sell optical wavelength and optical transport services. We intend to sell these services to existing customers, acquired customers from Sprint Communications and to new customers. These customers require dedicated optical connectivity without spending capital and the associated ongoing operational expense of owning and operating their own network infrastructure.

As part of our transaction with T-Mobile, we entered into a IP Transit Services Agreement on May 1, 2023. T-Mobile will be purchasing an aggregate of $700 million of transit services over the next 54 months from Cogent. This consists of equal payments over the next 12 months totaling $350 million or approximately $29 million a month. We will then receive for the subsequent 42 months an additional $350 million equally spread out monthly or approximately $9 million a month. We will recognize the associated $700 million of transit revenue services from T-Mobile on a straight line basis over 54 months or approximately $13 million a month.

To remind investors, this is a product that carries a 100% EBITDA margin contribution as it is completely on-net and the available capacity to deliver these services already exists in Cogent's infrastructure. In addition, we signed a series of transition-related agreements. On closing, we entered into a transition services agreement in order to receive specific services in order to maintain an orderly transition of the business. These transition services are primarily related to information technology, back office and finance support facilities and real estate vendor and supply chain management and human resources support from T-Mobile. These services will be provided under a transition services agreement.

In addition, we entered into a reverse transition services agreement where we will be providing necessary technology, network support, finance and back office support to support the remaining wireless components that are located in facilities that we acquired. Our initial transition services expense monthly is anticipated to be approximately $1.7 million to be paid to T-Mobile. And the costs under the reverse transition services agreement, paid for by T-Mobile to Cogent will approximately be $100,000 per month. These initial transition costs may fluctuate and are expected to diminish over time as each party migrates into its own systems, the services that were previously rendered under the transition services agreement.

The transition services agreement calls for these services being able to be provided for a 2-year period with the ability of either side to request a 1-year extension. Third-party costs incurred in providing these services will be passed on at cost with no additional margin. Either party can transition off of these services with 30 days with notice. In addition to the transition services, we will be selling commercial services to T-Mobile outside of the transit agreement.

Our commercial relationship with T-Mobile includes the services of colocation, space and power, connectivity at either Layer 1 or Layer 2. This commercial services agreement will result in T-Mobile paying Cogent approximately $2.7 million a month in cash for these initial services and this may also fluctuate

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and diminish over time. This is in addition to the $700 million IP transit services that we'll be providing to T-Mobile over the next 54 months. T-Mobile has indicated that on day 1, they will initially use a portion of these services.

In addition, we had the opportunity at Cogent to materially expand our network reach and footprint. We are adding 45 Sprint data centers to the 55 Cogent data centers that we operate. All of these facilities that we're acquiring from Sprint are fee simple owned. So the 100 Cogent data centers are in addition to the 1,490 carrier-neutral data centers that the combined company connects to. We are adding 18,905 route miles of owned in our city fiber. We are also adding 12,000 -- 1,257 route miles of owned metropolitan fiber. And finally, in conjunction with this acquisition, we are adding approximately 11,400 miles of intercity IRU fiber acquired from Sprint and 5,560 route miles of metropolitan IRU fiber also acquired from Sprint.

Now for a comment on our dividends. During the quarter, we returned $45.3 million to our shareholders in form of regular quarterly dividend. Our Board of Directors reflected on the strong cash flow generating capacity of our business, the investment opportunities, inclusive of the Sprint acquisition and all of its requisite cash flow streams and decided to increase our quarterly dividend sequentially by $0.01, raising our sequential quarterly dividend to $0.935 from $0.925. This represents our 43rd consecutive sequential month of growing our regular dividend. Our dividend growth rate now stands annualized at 6.3%.

Now in terms of guidance, the company does not give specific quarterly guidance. However, with the combination of the Sprint Wireline business and the Cogent business, we anticipate a long-term growth rate of approximately between 5% and 7% annually. EBITDA margins for the combined business should expand at an annualized rate of about 100 basis points a year once we have been able to achieve these initial synergies. This does not include the expectation of the $700 million in IP transit revenue from T-Mobile. Our growth is exclusive of that acquired revenue stream. Our revenue and EBITDA guidance are meant to be multi-year goals and are not intended to be specific quarterly or annual goals.

Now I'd like ask Thad to read our safe harbor language, provide some further details on our operating performance for the quarter. And then following that, I'll conclude with a few statements and then we'll open the floor for questions.

Thaddeus G. Weed
CFO & Treasurer

Thank you, Dave, and good morning to everyone. This earnings conference call includes forward-looking statements. These forward-looking statements are based upon our current intent, belief and expectations. These forward-looking statements and all other statements that may be made on this call that are not historical facts are subject to a number of risks and uncertainties and actual results may differ materially. Please refer to our SEC filings for more information on the factors that could cause actual results to differ.

Cogent undertakes no obligation to update or revise our forward-looking statements. And if we use non-GAAP financial measures during this call, you will find these reconciled to the corresponding GAAP measurement in our earnings releases, which are posted on our website at cogentco.com. Like many companies, we continue to be impacted by the COVID-19 pandemic. Our risks related to COVID-19 and other risks are described in more detail in our annual report on our 2022 Form 10-K and in our quarterly reports on Form 10-Q.

Some comments on revenue. We analyze our revenues based upon network connection type, which is on-net, off-net and non-core. And we also analyze our revenue based upon customer type. We currently classify our customers into 2 types, NetCenteric customers and corporate customers. And with the Sprint acquisition, we will be adding enterprise customers to our mix.

Our corporate customers buy bandwidth from us in large multi-tenant office buildings or in carrier-neutral data centers. These customers are typically professional services firms, financial services firms and educational institutions located in multi-tenant office buildings or connecting to our network through our carrier-neutral data center footprint. Our on-net -- NetCentric customers buy a significant amount

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of bandwidth from us in carrier -neutral data centers that includes streaming companies and content distribution service providers as well as access networks who serve consumer and business customers.

Our corporate customer business represented 55.8% of our revenues for the quarter. Our quarterly corporate revenue declined year-over-year slightly by 0.6% to $85.6 million from the first quarter of last year and decreased sequentially, but by only 0.2%. We had 44,570 corporate customer connections on our network at quarter end, which was a sequential decrease of 0.6% and a year-over-year decline of 1.8%. For the quarter, the sequential impact of USF on our revenues was not significant. And year-over-year, the impact was positive at about $0.5 million from the first quarter of last year.

Our NetCentric business, which represented 44.2% of our revenues for the quarter had another solid quarter and grew sequentially by 2.7% to $68 million and grew by 7.8% on a year-over-year basis. Volatility in foreign exchange rates primarily impacts our NetCentric revenue. And on a constant currency basis, our quarterly NetCentric revenue increased year-over-year by 10.2%. We had 52,857 NetCentric customer connections on our network at quarter end. That was a sequential increase of 2.3% and a year-over-year increase of 6.8%. Beginning with our next quarterly report, we will begin to report enterprise customer revenue as a new customer type, as I mentioned.

Our on-net revenue was $116.1 million for the quarter. That was a sequential increase of 1.1% and year-over-year 3.1%. Our on-net customer connections were 83,268 at quarter end. And we serve our on-net customers in 3,190 total on-net multi-tenant office and carrier-neutral data center buildings. We continue to succeed in selling larger 100 gigabit connections and 400 gigabit connections in selected locations, and this has the impact of increasing our on-net ARPU, which again happened this quarter.

Our off-net revenue was $37.3 million for the quarter. That was a sequential increase of 1% and a year-over-year increase of 2.5%. Our off-net revenues are impacted by incorporated the cost savings we obtained from lower loop -- local loop prices into our pricing, and that is the impact of decreasing our off-net ARPU, which again happened this quarter. Our off-net customer connections were 13,785 at quarter end and we serve these off-net customers in about 8,400 off-net buildings. These off-net buildings are primarily located in North America.

Comments on pricing. The average price per megabit for our installed base declined sequentially by 6.7% to $0.25 and year-over-year by 20.4% consistent with long-term averages. The average price per megabit of our new customer contracts for the quarter was $0.10. That was a sequential decline of 20.9% and year-over-year 41.6%, and this was impacted by entering into some larger customer contracts during the quarter. Selling larger connections and larger contracts results in a change to our connection mix and has the effect of lowering our average price per megabit at a greater rate change than changes in our ARPU.

Related to ARPU. Our on-net ARPU for the quarter increased and our off-net ARPU continued to decline, but at a modest rate. This is from lower pricing, again, we're obtaining for off-net circuit vendors and we pass that savings on to our off-net customers. Our on-net ARPU, which includes both corporate and NetCentric customers, increased sequentially by 0.6% to $467 from $464. Our off-net ARPU, which is predominantly comprised of corporate customers, declined sequentially by 0.5% from $914 to $910 per connection. Churn is very stable. Our sequential quarterly churn rates for both on-net and off-net was around 1% and that's what they were for the quarter. Both on-net and off-net were 1% for this quarter and that was the same as last quarter.

In order to reduce our customer turnover, we employ a dedicated sales group that works to retain customers who have indicated that they are considering terminating their services with us [Technical Difficulty] we may offer pricing discounts to these customers in order to induce them to reverse their termination decision to purchase additional services from us and/or extend the term of their contracts with us. During the quarter, certain customers took advantage of our volume of contract term discounts and entered into long-term contracts with us for over 2,380 customer connections. That increased their revenue commitment to Cogent by over $21.9 million.

On EBITDA and EBITDA margin, we reconcile our EBITDA to our cash flow from operations in each of our quarterly earnings press releases. Seasonal factors that typically impact our EBITDA and our SG&A expenses include the resetting of payroll taxes in the United States at the beginning of each year, annual

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cost of living or CPI increases, seasonal vacation periods, year end bonuses paid to our employees and the timing and level of audit and tax services and recently Sprint acquisition costs and also annual benefit plan cost increases.

During the quarter, we incurred $400,000 of Sprint acquisition costs. And our EBITDA for the quarter including these costs decreased sequentially by $1.1 million and by $1.1 million year-over-year. Our EBITDA results were impacted by our materially increased sales rep headcount, annual CPI compensation increases and circuit and power costs related to our international expansion. Our quarterly EBITDA margin including the $400,000 of Sprint acquisition costs decreased sequentially by 110 basis points to 36.5% and year-over-year by 180 basis points.

Our revenue earned outside of the United States is reported in U.S. dollars and was approximately 26% of our total quarterly revenues this quarter. About 17% of our revenues this quarter were based in Europe and 9% of our revenues were related to the Rest of World operations, which is Canadian, Mexican, Oceanic, South American and African operations. The average euro to USD rate so far this quarter is $1.10 and the average Canadian dollar exchange rate is $0.74. If these averages remain at the current level for the remainder of this quarter, we estimate that the FX conversion impact on sequential revenues will be positive at about $0.6 million and year-over-year would also be positive at about $0.4 million.

Customer concentration, our revenue and customer base is not highly concentrated and our top 25 customers for the quarter were only about 6% of our revenues. Our quarterly CapEx for the quarter was $23.2 million. Supply chain uncertainty in purchases in anticipation of the closing of our Sprint acquisition caused us to shift our typical purchasing schedule for network equipment. These anticipatory investments were designed to ensure that we have satisfactory inventory levels of network equipment to accommodate our growth plans, including new wavelength product offerings as a result of our Sprint Wireline acquisition and the interconnection of our 2 networks together in multiple locations and to meet our customer needs.

Our finance lease IRU obligations are for long-term dark fiber leases and typically have initial terms of 15 to 20 years or longer and often include multiple renewal options after the initial term. Our IRU finance lease obligations were $320.4 million at quarter end. We have a very diverse set of IRU suppliers and we have IRU contracts with a total of 319 different dark fiber suppliers. Our quarter end cash and cash equivalents and restricted cash was $234.4 million. The $50.3 million of restricted cash is tied to the estimated fair value of our interest rate swap agreement.

Our total gross debt at par, including finance lease obligations, was $1.3 billion at quarter end and net debt was $1 billion. Our total gross debt to trailing last 12 months EBITDA as adjusted for Sprint acquisition costs. That ratio was 5.47x at quarter end and our net debt ratio was 4.46x. Our consolidated leverage ratio, as calculated under our note indentures, was 5.42%, and our secured leverage ratio was 3.50%. Our fixed coverage ratio as calculated under our note indentures was 3.24%.

We are party to an interest rate swap agreement that modifies our fixed interest rate obligation with our $500 million of 2026 notes to a variable interest rate obligation based on the secured overnight financing rate or SOFR for the remaining term of these notes. We recorded the estimated fair value of the swap agreement in each reporting period. And we incur corresponding non-cash gains or losses due to the changes in the value of the swap from changes in market interest rates. At quarter end, the fair value of the swap agreement decreased by $1.8 million from last quarter to a liability of $50.3 million. We are required to maintain a restricted cash balance with the counterparty equal to the estimated liability.

Finally, some comments on bad debt and days sales outstanding. Our bad debt expense was 0.8% of our revenues for the quarter. Our days sales outstanding was 22 days, which was the same at year end and is an excellent metric. These metrics may be impacted by our Sprint acquisition going forward. And with every quarter, I want to personally thank and recognize our worldwide billing and collections team members for continuing to do a fantastic amazing job in serving our customers and collecting from them.

I will turn the call back over to Dave for some final remarks.

David Schaeffer
Founder, Chairman, CEO & President

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Thanks, Thad. I'd like to now highlight some of the strengths of our network, our customer base and our sales force. First, we'll start with NetCentric. We've achieved excellent revenue growth in our NetCentric business. We continue to benefit from the increased transition of video to over-the-top and streaming, particularly in international markets. At quarter's end, we were on-net in 1,490 third-party carrier-neutral data centers and 55 Cogent-owned data centers for a grand total of 1,545 data centers, more than any other carrier is measured by third-party research.

The breadth of our coverage enables us to serve our NetCentric customers and allow them to optimize their networks and reduce latency. We expect we'll continue to widen our lead in this market as we project adding an additional 100 carrier-neutrals per year to our network over the next several years. In addition, we are adding 45 acquired Sprint data centers to the Cogent-owned footprint. We significantly expanded our network footprint with both acquired IRUs and owned fiber route miles.

At quarter's end, we directly connected to 7,864 networks. Again, this is more than any other carrier in the world. This represents a constellation of ISPs, telephone companies, cable companies, mobile operators and other carriers that allow Cogent direct connectivity to the vast majority of the world's broadband and mobile phone subscribers. At quarter's end, we had a sales force of 222 professionals focused solely on the NetCentric market. This is most likely the largest group of sales professionals focused exclusively on this segment in the industry. This sales force will be predominantly responsible for the sale of our wavelength products that we'll begin offering with the closing of the Sprint transaction.

Now for a couple of comments on [Indiscernible]. We are seeing some positive trends in our corporate business as work from home environment has become established as part of people's work week. We believe corporate customers are increasingly willing to upgrade their Internet infrastructure to support larger connectivity and facilitate remote work. Our corporate customers are aggressively integrating new applications that become part of the work world such as video conferencing. Users will require high capacity connections both inside and outside of their premises.

Our aggressive push to lower the cost of bandwidth and provide greater coverage has continued to increase corporate demand for our robust bidirectional symmetric 1-gig and 10-gig port offerings. Corporate customers are typically buying additional connections and carrier-neutral data centers to provide redundancy for their ad hoc virtual private networks to facilitate work from home. The continued improvement in the corporate segment, as we highlighted last quarter, will be both on even and long-term, but the underlying trends are favorable for our ability to return to long-term sustainable sequential growth in that business.

Now for some highlights on our sales force. We remain focused on the number of sales people and the productivity of those individuals. We continue to expand and improve our training programs, but we're also aggressive in managing out underperforming sales reps. On a sequential basis, our total sales headcount increased by 14 reps or 2.6%, 17.3% year-over-year to 562 reps. The number of full-time equivalent reps increased sequentially by 7.2% to 539 from 503, representing a 19.1% year-over-year increase in full-time equivalent sales reps.

Our sales force turnover remained stable at 4.7% per month in the quarter. That is significantly below the peak of 8.7% per month during the pandemic and is better than our long-term historical average of sales force turnover of 5.7% per month. We remain optimistic about our unique position to be able to serve small and medium-sized businesses in the central business districts of major cities in the 1,841 on-net multi-tenant office buildings connected to our network with over 1 billion square feet of net rentable space.

We're also very excited about adding a large enterprise customer base to our customer mix, and we will be reporting those enterprise customers as a separate customer type. We're also adding wavelengths or optical transport networking services to our product portfolio. We intend to report both the number of wavelengths sold and also report the total revenue of those wavelength services.

Currently, key indicators of office activity and workplace re-entry and leasing activities are improving, but still remain below pre-pandemic levels. We are encouraged that many tenants are moving forward, making network decisions and beginning to stabilize their network architectures for the new work environment.

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Certain corporations have downsized offices. And their requirements may actually increase the number of potential customers we have in a building as those buildings continue to see improvement in leasing activities.

Under our indentures, including the $250 million general basket, we have cumulative amounts available for dividends and buybacks that actually exceed the amount of cash we have on hand. We are diligently working to integrate the Sprint Wireline acquisition. We remain excited and optimistic about the accelerating cash flow generating capabilities of these assets. Over the next 3 years, we continue to expect to achieve annualized savings in the order of approximately $220 million, as I indicated earlier. We also have additional SG&A savings and enhanced revenue synergies by cross-selling our wavelength services. This will allow Cogent to both grow scale and free cash flow.
With that, I'd like now to open the floor for questions.

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Question and Answer

Operator

[Operator Instructions] Our first question comes from the line of David Barden from Bank of America.

David William Barden
BofA Securities, Research Division

Congrats on closing the deal on Monday, Dave. I guess if I could ask 3 questions on the Sprint transaction. First, Dave, thanks for that color around the reporting. I guess just to be more clear, that you're going to be adding a revenue line to the reporting structure and then adding these 2 incremental customer count numbers. Any other disclosures that you plan on sharing on a go-forward basis would be helpful on that basis.

The second would be, should we be expecting any kind of CapEx requirements to either integrate or perfect the Sprint asset to accomplish some of what you hope to achieve on both the revenue and the savings targets? And then the last one, if I could, is you have a spectrum of pricing strategies that you've come to market with that have been successful over the years, super aggressive in data centers, moderately aggressive in bandwidth connectivity for buildings. How do you think about approaching these new opportunities in dark fiber wavelengths and lit services from a pricing and profitability strategy standpoint?

David Schaeffer
Founder, Chairman, CEO & President

Thanks for the 3 questions, Dave, and I'll try to take these in order. Our goal is to continue to be very transparent and consistent in the way we report revenues. We will have a third class of customers. We historically have sold to SMBs, which we classify as corporate and to service providers, whether they be content or -- content or access, which have been classified as NetCentric. With the acquisition of the Sprint GMG business, we are picking up a significant number of large enterprise customers. I think it will be very helpful for investors to see that customer type called out separately, both by unit number of connections and revenue.

We also will be reporting on products as we do today. We report our Internet access revenues, which are about 81% of Cogent's revenues, our VPN services, which are primarily VPLS with a small amount of SD-WAN at about 16% of revenues. And then our colocation revenues as space and power and about 3% of revenues. To those 3 products, we will be adding a fourth product that will be the optical transport networking or wave line services. We intend to report the number of wavelengths in service each quarter, and we intend to report the dollar revenue associated with those wavelengths. I think this will allow investors to track accurately our progress in achieving our revenue objectives.

We also anticipate an increase in our noncore reporting line due to the fact that while we are actively trying to end of life, many of these noncore gross margin negative products, the transaction did close sooner than anticipated. We do have more of that revenue than we expected, and we are burning it off. And as we said, we anticipate the revenues to go from a run rate of about [$490 million at closing to a run rate of $440 million] and then be stable. There will be some small stub of noncore products, and we will again report that as a separate line item that is both nongrowing and nonstrategic.

Now I'm going to pivot to your CapEx question. And I'm going to answer it in 2 windows. One, we have said and expect this to continue that we are spending about $50 million in CapEx to integrate the 2 networks. We have already spent the majority of that CapEx, but there is still some that is being spent. What is that money for? It's to connect the Sprint network in 100 U.S. markets to the Cogent network. And that usually requires physical fiber. We're both buying IRU fiber where available and physically trenching and building fiber where necessary. We are more than 50% of the way through that process, but those are onetime expenses. We do not anticipate any other onetime expenses.

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Now to kind of understand the ongoing CapEx of the combined business. There are really 3 components: roughly $35 million annually in maintenance CapEx, which includes capacity augmentation, but not footprint expansion in the Cogent network, about $30 million annually for CapEx to support the acquired Sprint network or therefore, about $65 million in maintenance. In addition to that, we expect to continue to spend approximately $30 million a year in footprint expansion, adding either new international markets or new data centers and a few new multi-tenant buildings in markets that we are already in. And we anticipate that being kind of our steady state number going forward.

Now to your go-to-market strategy question. It is true that in the customer base that we'll be selling wavelengths to Cogent has reputation of being exceedingly aggressive on pricing. We will be aggressive, but we do not believe that we have the same need to be as aggressive as we were in gaining market share in transit. Cogent entered a crowded market 20 years ago. We've become the #2 provider in the world, probably exit this year as the #1 provider with about 25% market share in transit due to our aggressive pricing. In the wavelength market, we are, today, less than 1/2 of 1% of that market based on the test bed that T-Mobile had funded for Sprint.

However, going forward, we will have some significant market advantages. 1) we will have unique routes and over 90% of the instances; 2) we will have more endpoints available to buy wave line services than any other carrier; 3) because of the homogeneous nature of our network, we can provide accurate routing maps within 1 meter of accuracy for diversity planning purposes that has great value to customers; 4) and maybe most importantly of all, Cogent today provisions on net services at an average of 9 days, we guarantee to do that in 17 days. The market for wavelengths expects provisioning to be somewhere between 90 and 200 days. We will go to market initially with a 90-day service level agreement for installs, but we expect over a 2-year period as we fully interconnect the networks to be able to get down to a level of approximately 9 days with a 17-day guarantee. And then finally, because we have a negative basis in the network, we will be aggressive, but we'll use pricing only as needed. Hopefully, that was helpful in answering your question.

Thaddeus G. Weed
CFO & Treasurer

Let me go back just to the revenue classification. So when we look at what the face of the income statement is going to look like in the 10-Q for the second quarter, we'll continue to have on-net, off-net and noncore, and that will include the Cogent, I'll call it Cogent Classic operation, and the Sprint acquired business will be included into those categories, along with some existing wave business, which will have a separate line that was acquired from Sprint and then new wave sales. So we'll have on-net, off-net, noncore wave revenue will also because of its materiality, need to separately one line the revenue from the IP transit agreement, the $700 million recognized straight line over the term as a one line. And we'll also disclose the revenue from the commercial arrangement with Sprint that starts at the initial rate that we mentioned in the script. So that's what the face of the income statement will look like. Underneath that, in the metrics, we will disclose the customer categories, which will include enterprise customers, the new classification for this quarter. I hope that helps.

Operator

Our next question comes from the line of Walter Piecyk from LightShed Walter.

Walter Paul Piecyk
LightShed Partners, LLC

I'm trying to -- so when you -- on the KPI type stuff, you have like sales force and then full-time equivalent reps. I'm not sure which one is more correlated corporate, but they both seem to be up like 15% over the past 3 quarters. I'm just curious if that should be indicative of maybe returning to growth in corporate in the upcoming quarters? I mean, do you see -- I understand that the productivity initially is low, but as these new people ramp up and your churn is lower, I guess, on employees. Is that going to lead to some growth in corporate in the next couple of quarters? And then I think kind of tied to that because I know that you'd like to give very full answers.

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In your prepared remarks, you were referencing corporate in terms of like customers adding more capacity for employees outside of the office totally get that. But what about the kind of narrative that you were giving, I don't know, about a year ago of this concept of like if the law firm goes from 3 floors to 1 floor, they can lease out 2 more floors and now we're seeing that corporate vacancies are not, in fact, recovering and no one is taking those 2 additional floors. So in terms of growth driven by actually signing up new corporate customers? Or are we all just leaning heavily on hoping that everyone is getting fatter and fatter pipes?

David Schaeffer
Founder, Chairman, CEO & President

Yes. So let's start with some clarifications and definitions on the sales force. We disclosed the total number of salespeople. We also disclosed a full-time equivalent, which is someone who's undergone 3 months of training. For those first 3 months, they don't have a quota responsibilities. Therefore, they're not [Technical Difficulty] a full-time equivalent, meaning they're carrying a quota. We've also disclosed that average rep productivity typically linearly improves from the end of that FT transition from trainee to full time equivalent to about month 30 where they mature.

We also are growing the total sales force, but are still below our pre-pandemic sales headcount numbers. We peaked at slightly over 600. We're at about 560 today. Now we troughed during the pandemic at about 470. The primary reason for that trough was the elevated level of turnover due to the lack of performance. Now we attribute that both to market conditions but also the inability to train reps as effectively and manage them most effectively remotely. So Cogent return to the office and remains a 5-day in the office company.

In terms of the split, we actually disclosed the number of reps that focus on NetCentric, the number of reps that focus on corporate. We will also begin to disclose the number of reps that focus exclusively on large enterprise. So we'll have 3 categories, and you could track their growth or decline in each category, each quarter. The productivity metric is one that is spread across all groups. So it's a little, I think, too much data and not really additive to break down productivity by rep type, they're relatively equivalent. And the goal here is to give useful KPIs and not KPIs that obfuscate key trends.

Now to your underlying question about corporate growth rates. We did have a couple of quarters of positive growth sequentially. This quarter dipped to negative [0.2%]. We've been very clear that a year or 18 months ago, we expected a more rapid return office and recovery in corporate. And a couple of quarters ago on the earnings call, I was very specific in saying that this is taking longer, it's going to be less even and slower than we anticipated. We are seeing improvements. We are seeing corporate ARPUs go up. We are seeing revenues effectively flat now as opposed to declining, not the 11% year-over-year growth we were accustomed to, but I do believe we'll get back to it.

Now I'm going to go back to your leasing comment. While it is true that the average lease size is declining, vacancy rates in all major U.S. markets have peaked and are declining. But again, the rate of decline is very modest. If you looked across the actual buildings that Cogent is in pre-pandemic, they had about 6% vacancy. That peaked at about 18% vacancy. It's down to about 17.2% today. So it's not materially better, but it is better and it's not getting worse. So we are seeing some improvement in occupancy, which then increases tenant count. We've also seen this migration of customers taking additional ports in data centers for backup and a larger port size. All of these have probably buffered some of the decline in pure units.

So if you look at the revenue decline from pre-pandemic corporate to now, it's much more modest than the decline in units, which is about 10%. It is getting better. But again, I want to be as transparent as I can. We don't have perfect visibility, but it does appear that the corporate business is improving, but at a slow and uneven pace.

Walter Paul Piecyk
LightShed Partners, LLC

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Doesn't it concern you that a lot of these economists are talking about how recession will specifically hit that market, so that if it went from [6 to 18, maybe down to 17, maybe down to 16], but by the end of the year, it's going to get worse rather than better.

David Schaeffer
Founder, Chairman, CEO & President

So again, we have been in operation through at least 4 other recessions, including the Great Recession, which was probably a more profound shock to the system. And our tenant base tends to be more recession-proof because they tend to preselect the most desirable buildings with the highest credit screenings and are generally not the businesses that go out of business in a recession. I do believe that the underlying owners of these real estate assets are in significant trouble. I as a real estate owner, myself, can tell you the pressures are material.

Most of the lending, the office market comes from regional banks who are under tremendous pressure. And while rent rolls are down, the banks need liquidity and are basically not willing to refinance assets as they mature. That's what's putting more pressure on the real estate market than necessarily the increase of vacancy rates. And while I do think monetary policy is going to continue to slow the economy and most likely cause a recession. I don't think that's going to materially impact the tenants that we sell to.

Walter Paul Piecyk
LightShed Partners, LLC

Okay. And just -- that's a good segue to my final question, which is, can you just remind us on the capital leases, what you're paying, what rate you're paying there? And is there anything in terms of maxing that out? Because obviously, when you're -- if your dividend is consuming more than the free cash flow it's the gross debt increase is showing up in capital leases. Is there a max on that? And is it -- what's the rate you're paying? I mean we had to call with SBA earlier. They had a loan that they're obviously paying down rather than buying stock back. Is that part of the consideration for that part of your debt instrument.

David Schaeffer
Founder, Chairman, CEO & President

Yes. So first of all, in both of our indentures, we have no limitation on our ability to enter into capital leases. In many cases, these leases are prepaid, meaning we pay an upfront fee and don't pay anything else other than a maintenance fee over time. The underlying interest rate that's imputed depends on the rates when the lease was signed. I'll let Tad touch on that.

Thaddeus G. Weed
CFO & Treasurer

Yes. The average which we disclosed in the 10-Q for all the leases is about 8%. And as Dave...

Walter Paul Piecyk
LightShed Partners, LLC

Right. But Tad -- right, which is not low. And then if you -- if that rises, your capital lease balance rises, like, let's say, went up to $15 million, $20 million. What's the new $15 million coming on at?

Thaddeus G. Weed
CFO & Treasurer

No. The lease is recorded when the route is accepted at the rate at that time, and it's not changed. So the rate used for the next month is the new range. And if the rate goes up, the value of the leases will actually come down on new leases.

Walter Paul Piecyk
LightShed Partners, LLC

Understood.

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David Schaeffer
Founder, Chairman, CEO & President

But the existing leases are not floating into...

Thaddeus G. Weed
CFO & Treasurer

Yes, but they don't change.

Operator

Our next question comes from the line of Nick Del Deo of MoffettNathanson.

Nicholas Ralph Del Deo
MoffettNathanson LLC

Dave, first, I wanted to ask kind of the same question I've asked since you announced the Sprint deal, which is basically, can you update us regarding customer interest and any commercial traction you've had in waves and dark fiber. It seems like it's been pretty positive to date, and it'd be interesting how it's evolved now that the sales team had a few months under their belt to sell waves and whether you've closed any dark fiber deals that you may have been negotiating pre-deal?

David Schaeffer
Founder, Chairman, CEO & President

So, 2 different answers to 2 different questions. On waves, which is a product that we've standardized and began selling on a resale agreement with Sprint. We've sold several dozen waves pre-closing and have a backlog of several hundred in the Q that we can now process since they are truly on-net. We no longer have a 2-step process to get those waves approved. We also looked at albeit a test bed, the Sprint Wave product and are simplifying that product to make selling even easier. We have integrated the ability to sell waves into our CRM system, which allows for instantaneous quoting as opposed to a multi-day process previously at Sprint. And I would say the demand for waves has actually been more robust than we anticipated.

Secondly, we've been surprised at the ability to cross-sell, meaning existing customers taking waves, but also we've had customers that were in our prospect funnel NetCentric customers that we haven't sold to that now are interested in buying from us because we can sell them both waves and transit. So we have laid out a target to grow the wavelength business from a run rate and acquisition of about $8 million, and that was purely a test product for T-Mobile to within 7 years, a $500 million revenue run rate for Cogent. We feel quite confident based on the backlog, we're probably going to beat our internal estimates of how quickly we will get there. So we remain really positive on the wavelengths.

Dark Fiber is different. It's very route-specific. Some routes are in more demand than others. We quite honestly have a lot of experience as a buyer, not a lot of experience as a seller. And because these are long-term agreements, we're going to enter into them cautiously. We have actually only executed 1 dark fiber agreement that actually we couldn't consummate until the deal closed. So it was a conditional agreement. But we are going to be selective. We have not factored dark fiber into our revenue projections. We view that as additive. And I think we'll be prepared maybe in a few quarters to have enough experience on market demand to really lay out a realistic set of expectations for investors. But today, it's not in our guidance, it's not in kind of our forecast and it will be viewed as an opportunistic sale.

Nicholas Ralph Del Deo
MoffettNathanson LLC

Okay. That's all very encouraging, especially in waves. Should we think that ARPU for wave is being a few thousand bucks a month per unit, something in that range?

David Schaeffer
Founder, Chairman, CEO & President

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Yes, I think it will actually be a little bit higher than that, Nick. So today, the market is dominated by 100-gig waves, but there are still some 10-gig waves. The Sprint product divided the country into 3 zones, and it was sold on kind of a zone basis. Are you in Zone 1? Do you go between Zone 1 and 2 or Zone 1, 2 and 3, much like the London subway system. We're actually going to collapse that down to 2. We also don't have the same constraints in metro that they had where they typically had to go out and buy a metro link to then complete the wave sale. So I think we'll do -- we'll dippy down to 2. I think for 100-gig waves, probably the $2,500 range is the way to think about it. For 10-gig waves, probably $800, $900 is a reasonable price in the market. Again, a little bit of variance, whether it's 1 or 2 zones.

And then there is a nascent but developing 400-gig wave market that we'll participate in. I think that will become realistic in '24. And I would suspect the percentages of 10-gig waves to continue to decline and eventually the 400s will replace some of the 100s and become its own category. While we have not established pricing for that, and there's not really much of an existing market today, the pattern has been that if you 4x the capacity, you roughly double the price, so call it a $5,000 product. I think it's probably a reasonable way to think of a 400-gig wave, but that's something we won't be selling until sometime in '24.

Nicholas Ralph Del Deo
MoffettNathanson LLC

Okay. Okay. That's super helpful. And maybe Dave, can we just touch on kind of traffic growth and NetCentric growth? I think you said traffic growth was 3% sequentially kind of soft for what's seasonally usually a strong quarter for you. NetCentric growth decelerated quite noticeably Q-over-Q. Anything we should be aware of or concerned about when viewing those trends? And what should we expect out of that business from here kind of near term and long term?

David Schaeffer
Founder, Chairman, CEO & President

Yes. So we grew 3% sequentially, 20% quarter over -- year-over-year. There was some deceleration. It tends to be lumpy around customers just as price per megabit of new sales. Now over the long run tends to kind of even out in the quarter, more of our sales were to very large customers, that kind of reversed the trend of the past year, where it was more smaller customers. The trend is still international growing faster than domestic, and it also is a trend of us gaining market share. I would suspect the NetCentric business that on a revenue basis, constant currency was a 10.2% grower. It's still above long-term trend line. It is slower than the peak of the pandemic, but it does appear the funnel looks pretty good, and we will probably continue to grow above trend line for the next year. That's probably the visibility we have.

Operator

Our next question comes from the line of [Michael Collins] from Citi.

Unknown Analyst

Curious if we could go back to the corporate segment. And just curious if you can unpack a little bit more about the types of demand you're seeing in terms of the connections per customer in the corporate building and then the demand around VPN and off-net. And for the other services beyond the core connection that you offer, do you see that as a tailwind for corporate revenue growth in the future or a possible headwind in some way?

David Schaeffer
Founder, Chairman, CEO & President

Yes. So I think 3 different questions there and one. So the vacancy rate in the building is materially up. So there are less businesses. Even though the new leases are smaller in response to Walt's question, they're not a material part of the base yet. So the TAM is today smaller than it was pre-pandemic, but it is growing. Second, the average connection size is getting bigger, which is pulling up ARPU. Third, more and more customers, not yet quite a majority but a significant minority are also taking ports in data centers. That's a kind of post-pandemic trend and the realization that they need redundancy for their ad hoc VPN concentration.

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The fourth point is dedicated VPNs, whether they be VPLS or SD-WAN are less important than they were pre-pandemic. More customers are willing to just use the Internet, but VPN still remain approximately 16% of our total revenues and about 16% of new sales. So we have not seen a significant shift away from encrypted or encapsulated services over the Internet, where the shift is away from VPNs that don't ride the Internet. And while we saw a slowdown in the rate of MPLS conversion during the pandemic, we're starting to see a reacceleration of the transition to either DIA or VPLS or SD-WAN. So I don't think that is a material headwind.

The final part of your question results in branch offices. There is a continued grooming of companies removing branch offices, shutting them down, that is a headwind. But that has been actually more than offset by the availability of fiber to more endpoint locations. All of the regional fiber overbuilds, which are predominantly focused right now on residential customers also expand the commercial footprint. And we are now able to buy off-net fiber-based services in over 5 million commercial buildings. That's a 25% increase over the past 18 months. I mean that's a pretty rapid increase and where we can sell off-net. And as a result of that, we can actually now see off-net revenues continuing to grow, even though ARPUs are declining because of competitive pressures between the various off-net providers. And if you look at our numbers, that's really been the case for the past couple of years, and that trend is going to continue. So when we kind of net out both the headwinds and tailwinds, I think that they're kind of neutral. And we're really dependent on corporate customers just making a decision and not procrastinating than necessarily going out of business. It was really the premise of one of the earlier questions.

Unknown Analyst

Do you go back to some of those free promotions you used to get in and show how you work and how the service performs and then get the attacks when they're ready to renew with whatever cycle that they're on? Is that the -- was that a good approach last time that you used it?

David Schaeffer
Founder, Chairman, CEO & President

It was an excellent approach. We are not doing that at this point in time. But promotions are meant to be temporary. And our expectation is we will have some try and buy promotions later this year.

Operator

Our next question comes from the line of Frank Louthan from Raymond James.

Frank Garrett Louthan
Raymond James & Associates, Inc., Research Division

Can you give us an idea of some of the main areas where the Sprint unit is seeing the EBITDA pressure? And what are some of the things you can do to get those costs out. I think you said it would take maybe 2 years to get to breakeven, how quickly can you do that? And then lastly, when can you begin to take down some circuits and move some of that traffic over to GMG to get some better savings?

David Schaeffer
Founder, Chairman, CEO & President

So we actually started the process of moving circuits pre-closing through a series of agreements with T-Mobile. Our primary area of focus was initially international. And the reason for that is 100% of Sprint's network outside of the U.S. was on leased facilities. Almost all of Cogent's network outside of the U.S. is on IRU fiber. We are continuing that process and anticipate being able to bring all of the international savings out probably in the first year. Domestically, it's more difficult for a couple of reasons. One is a lot more customers. Cogent is approximately 75% on-net. Sprint is approximately 7% on-net. So we are migrating several thousand customers from being off-net to on-net. That process has begun, but just because of the customer count and customers' contractual terms, it's going to take more than a year to complete that exercise.

We also will be taking out lease circuits that Sprint had domestically. We will be eliminating some of that Sprint IRU fiber because it's duplicative with what we have. We also will be densifying our off-net footprint

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and consolidating our contracts. Now because there are existing Sprint take-or-pay contracts that still have term, we -- no matter how fast we move, we can't take all of those costs out in year 1. And that's why we've laid out this waterfall of cost savings. The work has already begun. We got the burn rate at signing down from negative $300 million of EBITDA to negative $190 million or $180 million between USD180 million and USD190 million at closing, and we'll get that down to negative $80 million within a year after closing and get it down to 0, 2 years post closing, which when you layer on the additional transit revenue that we'll be receiving from T-Mobile means that we're cash flow accretive from day 1. We're pretty confident that we're moving as quickly as possible and investors will see the savings.

Operator

Our next question comes from the line of Brandon Nispel from KeyBanc Capital Markets.

Evan Lewis Young
KeyBanc Capital Markets Inc., Research Division

It's Evan Young on for Brandon. I was just looking to see if you could provide any more color on your OpEx throughout the rest of the year. And if you think that Q1 would be the high watermark for the year?

David Schaeffer
Founder, Chairman, CEO & President

Yes. So Q1 tends to be our highest quarter in terms of extraordinary expenses or audit expenses. We did have some bonuses last quarter in Q4 that were extraordinary to offset CPI increases, so instead of CPI, we granted onetime bonuses. But I think we should continue to see some improvement in SG&A. Part of that, though, will be offset by our anticipated growth in sales force. We also will have a number of onetime expenses on the OpEx side related to perhaps further severance and employees. Many of those costs under our purchase agreement with Sprint or reimbursed by Sprint.

I'll let Tad maybe give you any other detail.

Thaddeus G. Weed
CFO & Treasurer

Yes. The first quarter, Dave mentioned and I think in the prepared remarks, we mentioned, obviously, we have the resetting of payroll taxes and there's also a lot of vacations taken in the fourth quarter, and you're rebuilding the vacation reserves in the first quarter. So those cumulative amounts are a couple of million dollars in the first quarter, plus-plus compared to the fourth quarter. We're also -- we are going to have in the second quarter, we had our annual sales meeting. So that's going to be about $1.5 million in a nonrecurring expense. We had that in April. So net-net, we should see a decline in SG&A from Q1 to Q2, depending upon how many sales reps we've managed to hire by the end of the quarter.

Operator

There are no further questions at this time. I turn the call back over to our speakers.

David Schaeffer
Founder, Chairman, CEO & President
All right. Well, I'd like to thank investors for their time today. I appreciate the interest in Cogent. Hopefully, we've given you some additional granularity and color on our future reporting. We also want to provide this information in a consistent way that will help you model Cogent, hold us accountable for the commitments that we're making and give you the clarity around the key trends in our business. So again, I want to thank everyone for their time. We look forward to seeing you soon at conferences and are most excited about the opportunity to take the Sprint asset, which has been underappreciated and under use and generate meaningful free cash flow quickly. Thank you all very much. Take care. Bye-bye.

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