Cogent Communications (Q3 2020 Earnings)
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Corporate Speakers:

- Dave Schaeffer; Cogent Communications; Chairman & CEO
- Sean Wallace; Cogent Communications; CFO

Participants:

- Phil Cusick; JPMorgan Chase & Co.; Analyst
- Frank Louthan; Raymond James Financial; Analyst
- Colby Sinise; Cowen Inc.; Analyst
- Walter Piecyk; LightShed Partners; Analyst
- Michael Rollins; Citigroup Inc.; Analyst
- Nick Del Deo; MoffettNathanson LLC; Analyst
- Tim Horan; Oppenheimer Holdings; Analyst

PRESENTATION

Operator^ Good morning, and welcome to the Cogent Communications Holdings Third Quarter 2020 Earnings Conference Call and Webcast. As a reminder, this conference call is being recorded, and it will be available for replay at www.cogentco.com.

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

Dave Schaeffer^ Hey, thank you, and good morning to everyone. Welcome to our third quarter 2020 earnings conference call. I'm Dave Schaeffer, Cogent's Chief Executive Officer. With me on this morning's call is Sean Wallace, our Chief Financial Officer.

We continue to believe in the long-term strength of our business, the growing importance and breadth of our network and the increasing profitability of our operations. We also remain confident in the importance of our products and services to our customer base, which continues to utilize Cogent's Internet service for their mission-critical operations. Fundamentally, the interconnectivity and volume of traffic among businesses, service providers, carriers and data centers continues to grow at extremely high rates and we operate important infrastructure that supports that growth.

As discussed in previous earnings calls, our churn remains within historical averages and we are not seeing any significant changes to our customer base. However, we are continuing to see new and existing customers take a cautious approach to new configurations and upgrades as well as continued reduction in demand for services at smaller satellite offices for our corporate customers. We continue to see challenges and uncertainties related to incremental sales directly related to the COVID-19 pandemic.

Our third quarter revenues grew sequentially at 0.9% to $142.3 million and increased 3.9% on a year-over-year basis. On a constant currency basis, we experienced quarterly revenue decline of 0.2% and achieved a year-over-year quarterly revenue growth on a constant currency basis of 3.1%. We continue to operate an efficient network, which serves a growing number of markets, buildings within those markets and is able to handle the continued growth in traffic volume on our network.

Our non-GAAP gross profit grew by 0.8% sequentially and 7.5% year-over-year despite a modest decline in margins. Our non-GAAP gross margin improved by 200 basis points year-over-year. Continued disciplined expense controls enabled us to reduce the level of our SG&A quarter-on-quarter. At the same time, we supported a 4.4% sequential increase in the number of sales reps selling our products. As a result, our EBITDA margin improved to a historic high of 38.4%, which was a 60 basis point sequential improvement and a 150 basis point year-over-year improvement. Our EBITDA grew sequentially by 2.3% and 8.1% year-over-year.

The performance of our existing customer base continue to be strong despite the impact of COVID-19. Customer churn, bad debt and DSOs outstanding remained within our historical norms and our cash collections for the quarter performed above expectations. We believe that these statistics indicate the strong credit quality of our customer base and the importance of Cogent services to those organizations.

Towards the end of the quarter, we began to see positive trends in network traffic. The reintroduction of sporting events and the reopening of schools even with remote learning, reinvigorated traffic growth. For the third quarter, traffic growth grew slightly less than 1% on a sequential basis and grew 35% year-over-year. September was the best month of the quarter in terms of traffic growth. And our October traffic growth acceleration continued and was approximately 8% above the traffic volumes of September.

During the quarter, we returned $32.7 million to our shareholders through our regular quarterly dividend. We also purchased $3.3 million of common stock through October 31 and as of October 31, 2020, we had approximately $31.6 million available to us under our authorized stock buyback program, which our Board has authorized to continue through December 2021.

Our cash held at Cogent Holdings was $134.3 million at quarter's end. That cash is unrestricted and available to be used for dividends and/or stock buybacks. Cash held at our operating companies was $259 million at quarter's end, and our total combined cash was $393.3 million at quarter's end.

Our gross leverage ratio increased to 5.08 to 5.10 from quarter-over-quarter, and our net leverage ratio increased to 3.24 from 3.07. These leverage ratios increased primarily related to the $17.4 million increase in the U.S. dollar translated value of our $350 million of euro-denominated notes outstanding. Our consolidated leverage ratio is calculated under our debt indenture was 4.99 at quarter's end.

Our Board of Directors, which reflected on the strong cash generation capabilities of our business and looked at other investment opportunities, has decided to increase our quarterly dividend by another $0.025 per quarter sequentially, raising our dividend from to $0.705 per share in Q2 to $0.73 per share. The increase represents the 33rd consecutive sequential increase in our regular quarterly dividend, and our dividend growth rate is 14.1%.

Now I'd like to ask Sean to read some safe harbor language and give an additional update on COVID-19 and some review of our operating performance.

Sean Wallace^ Thank you, Dave, and good morning to everyone. This earnings conference call includes forward-looking statements. These forward-looking statements are based on our current intent, belief and expectations. These forward-looking statements and all other statements that may be made on this call 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. If we use non-GAAP financial measures during this call, you will find these reconciled to the GAAP measurements in our earnings release, which is posted on our website, www.cogentco.com.

An update on COVID-19. Like many other companies, Cogent continues to be impacted by the COVID-19 pandemic and the accompanying responses by governments around the world. Virtually, our entire workforce continues to work remotely. I want to thank the entire Cogent workforce and in particular, our IT department for their hard work during these challenging times. I also want to thank our field engineers, contractors and other employees who continue to work on the front lines, installing our new customers and maintaining and upgrading our network so that we can continue to serve our customers.

The ultimate impact of the pandemic on Cogent is unknown as a significant amount of uncertainty and volatility remains. We do not know the scope and duration of the pandemic, what actions governments may take in the future in response to the pandemic and how the pandemic will impact the economies of the world. While Cogent is working remotely, we have no assurance that this will be sufficient to protect our workforce and our key employees. Moreover, our results of operations may be adversely affected in the future as the pandemic and the related government restrictions continue.

We may see slowdowns in new customer orders, find it difficult to collect from customers who are experiencing financial distress, encounter difficulties accessing the buildings and locations where we install our new customers and serve existing customers, or have difficulties procuring, shipping or installing necessary equipment on our network. We may also find that our corporate customers, our largest customer base, which is served primarily in our on-net multi-tenant office buildings, may be adversely affected by falling demand for commercial office space in central business districts as company located in these buildings elect not to return to their office space, either on a temporary or even a permanent basis.

We have also seen our satellite office locations decline as certain customers either disconnect certain offices or elect not to purchase direct Internet access or virtual private network connections for smaller offices. The global economic impact of the COVID-19 pandemic may have prolonged effects that impact our business well into the future.

These and other risks are described in more detail in our quarterly report on Form 10-Q for the quarter that will be filed shortly after this call and in our annual report on Form 10-K for the year ended December 31, 2019, and in our quarterly reports on Form 10-Q for the quarters ended June 30, 2020, and March 31, 2020.

Throughout our discussion, we will highlight several operational statistics. I will review in detail certain operational highlights and trends. Following our remarks, we will open up the call for Q&A.

Now I'd like to turn it over to Dave.

Dave Schaeffer^ Thanks, Sean. Hopefully, you've had a chance to review our earnings press release. Our press release includes a number of historically accurate metrics and is presented in a consistent basis. Now for a few comments against expectations and targets.

Our corporate business represented 67% of our revenues this quarter. Our corporate business grew year-over-year by 1.3% from the third quarter of 2019 and fell by 1.3% and from the second quarter of 2020. Our NetCentric business, which represents 33% of our revenues, had a strong quarter and grew by 5.9% sequentially on a quarter-over-quarter basis and grew by 9.6% on a year-over-year basis from the third quarter of 2019. And an increase in USF tax rate has a positive impact on our corporate revenues sequentially, but a negative impact on a year-over-year basis. The USF tax rate changes quarterly, and we cannot predict the impact of future USF rates on changes in our revenue. Volatility in exchange rates primarily impact our NetCentric business.

On a constant currency basis, our NetCentric business increased 6.9% from the third quarter of 2019 and 2.3% sequentially from Q2 of 2020. Our long-term EBITDA annual margin expansion guidance remains at a targeted annual improvement rate of 200 basis points a year. Our multiyear constant currency long-term revenue growth target remains approximately 10%. Our revenue and EBITDA guidance targets are intended to be multiyear goals and not are intended to be used for any specific annual guidance.

Now Sean will provide some additional operational detail on our business. And then I'll come back to give a bit of a summary.

Sean Wallace^ Thanks, Dave, and again, good morning to everyone. Let me discuss our corporate and NetCentric revenue and customer connections. We analyze our revenues based upon network type, on net, off-net and noncore, and we also analyze our revenues based upon customer type. We classify all of our customers into two types, NetCentric customers and Corporate customers. Our Corporate customers buy bandwidth from us in large multi-tenant office building as well as carrier-neutral data centers. Our NetCentric customers buy significant amounts of bandwidth from us in carrier-neutral data centers.

Revenue and customer connections by customer type. Revenue from our Corporate customers for the quarter fell sequentially by 1.3% to $95.7 million and grew year-over-year by 1.3%. We believe that the slowdown in the growth rate of our Corporate revenues was directly impacted by the continuing concerns raised by COVID-19. While we continue to have significant dialogue with our existing and potential customers, some customers are delaying the upgrade of services or purchases of new services due to the uncertainty regarding COVID-19, mostly in off-net office buildings.

In many new sales orders, customers are reducing their aggregate number of locations, and this results in lower sales to satellite offices. The slowdown in sales combined with normal historical levels of churn, has contributed to a modest reduction in Corporate sales for this period. The higher USF rate, which only applies to corporate virtual private network connections increased Corporate revenues, while the continuing trend of lower local loop pricing reduced off-net Corporate revenue as we continue to pass on those savings to new customers. We had 47,722 Corporate customer connections on our network at the quarter end, which was a decline of 1.2% versus the second quarter, and a decrease of 0.9% over the third quarter of 2019.

Quarterly revenue from our NetCentric customers showed improved growth as revenues increased by 5.9% sequentially and increased by 9.6% annually. We had 40,787 NetCentric customer connections on our network at quarter end, an increase of 8.7% over the third quarter of 2019. Our NetCentric business benefited from continued strong demand for our larger 10 gigabits per second and 100 gigabits per second ports. Our NetCentric revenue growth experiences significantly more volatility than our Corporate revenues due to the impact of foreign exchange, large customer size and certain seasonal factors.

While traffic grew in our network by 35% year-on-year, primarily a result of increased NetCentric traffic this increase in traffic only partially created a corresponding increase in revenues as volume discounts and traffic mix, particularly for some of our largest customers, offset a great deal of this traffic growth.

Talking about revenue and customer connections by network type. Our on-net revenue was $105.1 million for the quarter, a sequential quarterly increase of 1.2% and a year-over-year increase of 5.7%. Our on-net customer connections increased by 0.5% sequentially and increased by 3.3% year-over-year. We ended the quarter with 76,338 on-net customer connections on our network in our 2,884 total on-net multi-tenant office and carrier-neutral data center buildings.

Our off-net revenue was $37.1 million for the quarter, a sequential quarterly increase of 0.1% and a year-over-year decrease of 0.9%. When we sell new off-net circuits, we incorporate savings from the lower local loop prices into our pricing and the introduction of these customers into the base lowers our overall off-net ARPU. Off-net customer connections were essentially flat sequentially and increased by 3% year-over-year. We ended the quarter serving 11,849 off-net customer connections and over 6,800 off-net buildings. These off-net buildings are primarily located in North America.

Pricing per megabit. Consistent with historical trends, our average price per megabit of both our installed customer base and new customer contracts decreased for the quarter. The average price per megabit for our installed base declined sequentially by 5.8% to $0.45 per megabit, and declined by 26.5% from the third quarter of 2019. The average price per megabit for our new customer contracts for the quarter decreased sequentially by $0.196 to $0.19 and declined by 44% from the third quarter of 2019.

Let's talk about ARPU. Our on-net ARPU increased and our off-net ARPU decreased sequentially and on a year-on-year basis. The year-over-year increase in our on-net ARPU reflects the growing importance and mix of our larger bandwidth products for the Corporate and NetCentric markets. During 2020, our 1 gigabit per second product surpassed our Fast Ethernet product sold primarily to our Corporate customers as our most popular port size and its continued growth is contributing to a higher on-net ARPU. Another product that is contributing to higher on-net ARPU is our 100 gigabits per second product sold primarily to NetCentric customers. The growth in units and the size of their respective ARPUs is having a positive effect on our on-net ARPU.

Our on-net ARPU, which includes both Corporate and NetCentric customers, was $460 for the quarter, an increase of 0.5% from last quarter. Our on-net ARPU increased by 1.6% from the third quarter of 2019. Our off-net ARPU, which is comprised of predominantly Corporate customers, was $1,044 for the quarter, a decrease of 0.4% from the last quarter. Our off-net ARPU decreased by 4.5% from the third quarter of 2019. Again, the impact of passing on lower loop prices is pushing ARPU lower, making us more competitive while at a consistent level of profitability.

Churn rates. Our on-net and off-net churn rates both increased sequentially for the quarter. Our on-net unit churn was 1.1% for this quarter, a slight increase from 1% last quarter. Our off-net unit churn was 1.5% for this quarter, an increase from 1.1% last quarter. As we have mentioned, the reduction in the need for satellite offices has resulted in lower off-net sales and a slightly elevated level of off-net churn.

Mac orders. In order to reduce our customer turnover, we employ a dedicated sales group, which works primarily to retain customers who have indicated that they are considering terminating their services. We typically offer pricing discounts to these customers in order to induce them to purchase more services and/or to extend the term of their contracts. Due to the commodity nature of NetCentric services, the vast majority of these move add or change orders are related to our NetCentric customers. During the quarter, certain of our NetCentric customers took advantage of our volume and contract term discounts and entered into long-term contracts with us for over 2,300 customer connections increasing their total revenue commitment to Cogent by over $24.1 million.

EBITDA. Our EBITDA is reconciled to our cash flow from operations in all of our quarterly earnings press releases. Seasonal factors that typically impact our SG&A expense this include the resetting of payroll taxes in the United States at the beginning of each year, annual cost of living or CPI increases, seasonal vacation periods, the timing and level of our audit and tax services, our annual sales meeting costs and our benefit plan annual cost increases. These seasonal factors typically increase our SG&A expenses in our first quarter from our fourth quarter.

Our EBITDA improved sequentially, primarily a result of a $1.3 million increase in our on-net revenue and a $0.5 million reduction in our SG&A expenses. Our quarterly EBITDA increased by 2.3% sequentially to $54.6 million. Our quarterly EBITDA increased year-over-year by $4.1 million or by 8.1%. Our quarterly EBITDA margin increased by 60 basis points sequentially to 38.4% and increased year-over-year by 150 basis points.

Earnings per share. Our basic loss per share was $0.11 for the quarter compared to income per share of $0.19 last quarter and $0.30 for the third quarter of 2019. Our diluted loss per share was $0.11 for the quarter compared to income per share of $0.18 last quarter and $0.30 for the third quarter of 2019. On realized gains and losses on the translation of our 2024 Euro notes in the U.S. dollars are the primary contributor to variability in our net income and consequently, our income or loss per share, in particular, in this quarter.

Foreign currency. Our revenue earned outside of the United States is reported in U.S. dollars and was approximately 23% of our total quarterly revenues. Approximately 17% of our revenues this quarter were based in Europe and about 6% of our revenues were related to our Canadian, Mexican, Asia Pacific, Latin American and African operations. We do not hedge our foreign currency obligations, including our payments on our euro notes. Our foreign operations generate sufficient cash to fund these international obligations, which we believe provides a natural hedge for these liabilities. Continued volatility in foreign currency exchange rates can materially impact our quarterly revenue results and our overall financial results. The foreign exchange impact on our reported quarterly sequential revenue was a positive $1.6 million and the year-over-year foreign exchange impact on our reported quarterly revenue was a positive $1.1 million.

Our quarterly revenue growth rate on a constant currency basis was 0.2% sequentially and 3.1% year-over-year. Variability in foreign exchange rates primarily impact our NetCentric customers. The average euro to U.S. dollar rate so far for this quarter is 1.18, and the average Canadian dollar exchange rate is 0.76. Should these average foreign exchange rates remain at the current average levels for the remainder of our fourth quarter of 2020, we estimate that the FX conversion impact on our sequential quarterly revenues for our fourth quarter will be a positive $0.2 million and the year-over-year FX conversion impact on our quarterly revenues will be a positive $1.4 million.

Customer concentration. We believe that our revenue and customer base is not highly concentrated. Our top 25 customers represented less than 6% of our revenues this quarter.

Capital expenditures. Our quarterly capital expenditures decreased by $0.6 million sequentially and increased by $1.2 million year-over-year. Our capital expenditures were $13.3 million this quarter compared to $12.1 million for the third quarter of 2019, and $13.9 million for the second quarter of 2020.

Finance leases and finance lease payments. 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 finance lease IRU fiber lease obligations totaled $212.9 million at September 30, 2020. At quarter end, we had IRU contracts with a total of 262 different dark fiber suppliers.

Our finance lease principal payments were $9.5 million for the quarter, primarily due to dark purchases of dark fiber in international markets, compared to $2.1 million for the third quarter of 2019 and $3.7 million for the second quarter of 2020. Our finance lease principal payments combined with our capital expenditures were $22.8 million this quarter compared to $17.6 million last quarter and were $14.1 million for the third quarter of 2019.

Cash and operating cash flow. As of September 30, 2020, our cash and cash equivalents totaled $393.3 million. For the quarter, our cash decreased by $23.7 million from a decrease in our operating cash flow and a decrease in cash from our financing activities. Our quarterly cash flow from operations decreased sequentially by 20.2% due to a decline of $9.8 million in working capital. Our quarterly cash flow from operations decreased by 1.4% year-over-year. Our cash flow from operations was $33 million for the quarter compared to $33.4 million for the third quarter of 2019 and $41.3 million for the second quarter of 2020.

Debt and debt ratios. Our total gross debt at par, including our finance lease IRU obligations, was $1.1 billion at September 30, 2020, and our net debt was $684 million. Our total gross debt to trailing last 12 months EBITDA as adjusted ratio was 5.10 at September 30, 2020, and our net debt ratio was 3.24. Our consolidated leverage ratio, as calculated under our debt incurrence agreements was 4.99 at September 30, 2020. Our EUR 350 million notes are reported in U.S. dollars and converted to USD at each month end using the month end euro to USD exchange rate. The unrealized foreign exchange unrealized loss on our Euro notes was $17.3 million this quarter or $0.38 per share as compared to an unrealized loss of $3.4 million last quarter and an unrealized gain of $6.2 million for the third quarter of 2019.

Bad debt and day sales outstanding. Our bad debt expense as a percentage of our revenues improved sequentially and year-over-year. Our bad debt expense was 0.6% of our revenues for the quarter compared to 0.9% of our revenues for the second quarter of 2020 and 0.7% in the third quarter of 2019. Our days sales outstanding, or DSO, for worldwide accounts receivable was 22 days for the quarter, unchanged from last quarter. I want to thank and recognize our worldwide billing and collections team members for continuing to do a fantastic job and serving our customers and collecting from our customers during very challenging times.

I will now turn the call back to Dave.

Dave Schaeffer^ Hey, thanks, Sean. I'd like to highlight a couple of strengths of our network, our customer base and our sales force. Cogent's network scale continues to grow due to the expansion of our physical network. We now operate in 47 countries. As we've introduced our services to new markets, the breadth of our network, of our sales force and our competitive pricing model has helped us grow demand and new services in these locations. Our initial success in South America and Africa indicates that we can profitably extend our network into new markets and our business model into many more countries.

We have today over 968 million square feet of multi-tenant office space directly on-net in North America. We operate 54 Cogent control data centers with over 606,000 square feet of raised floor space operating at 32% capacity. Our network consists of over 36,700 metro fiber miles and over 58,100 intercity route miles of fiber. Our focus remains to develop one of the most interconnected, high capacity Internet backbones in the world, and that strategy continues to bear fruit.

We now have directly connected to the Cogent network over 7,220 networks, up from 6,844 connected networks at this time last year. This collection of telephone companies, Internet service providers, cable companies, mobile operators and other carriers provides us access to the vast majority of the world's broadband subscribers and mobile phone users. This large collection of eyeballs and users positions Cogent as the go-to network for Internet applications and content providers.

The work-from-home environment continues to push our corporate on-net customers to upgrade their Internet connections to support greater infrastructure with larger connections for their work-from-home employees. As employees remain outside of the main office, corporations need high capacity circuits both in and out of these premises. Cogent's robust bidirectional symmetric 1 gig circuits have significant advantages over many other networks, which have overall capacity limitations and typically provide a symmetric traffic with only downstream capabilities. We believe we're well positioned to benefit from NetCentric customer demand growth for larger pipes.

Our network ubiquity, our operation in 47 countries and nearly 1,300 data centers. The large number of access networks that we connect to and the over 220 dedicated NetCentric salespeople who focus solely on this market and give us a huge advantage in terms of focus and understanding of our customer needs. Our 10 gigabit and 100 gigabit ports for NetCentric customers continue to grow at accelerating rates. While we have experienced a modest summer slowdown in traffic, as we typically do, the early part of -- in the early part of the third quarter with the reopening of schools, the reintroduction of sports and individuals returning to their homes, we've seen a reacceleration in traffic growth.

In the third quarter, our traffic growth increased sequentially through the quarter, and September was our busiest month. And we saw also a huge spike earlier in the year in March, and we're seeing similar trends in October with significant sequential improvement from September to October.

Now for a few comments on our sales force. We did experience continued sales productivity that was below our long-term historical trends particularly in our Corporate sales force, and those individuals have focused on multisite corporate opportunities. Our full-time equivalent sales force grew sequentially by 5.6% to 563 full-time equivalent reps selling our services at quarter's end, and our orders installed in the quarter were down 3.7%. As a result, our sales force productivity for the quarter was 3.7 installed orders per rep per month, which is a run rate that continues to be below our historic average. However, this was partially offset by the fact that our average port size continues to increase as reflected in our higher ARPUs.

As described earlier, we believe this decline in the number of orders, both from new and existing customers was as a result of uncertainty related to COVID-19 and the exact configuration of branch office locations for our Corporate customers. We also believe that our sales force productivity has been impacted from their work from home, which does somewhat limit our ability to train and view our sales force and has lowered our effectiveness in managing the exit of underperforming salespeople. We have taken a number of steps to more closely monitor those underperforming sales reps.

Sales force turnover increased to 4.6% per month in the quarter, which was higher than the 3.5% we experienced in the second quarter, but still below our long-term turnover rate of 5.6% of our sales force per month. While we wish no sales individuals would leave Cogent, we must remain diligent in managing those underperformers. Our sales performance was also adversely impacted by the implementation of our new customer relationship management system in July and August. Training for the system, software fixes resulted in reduced time for salespeople to focus on reaching out to customers. Partially as a result, July and August were the 2 weakest sales months in the past 2 years.

Our sales in September significantly reversed that trend, and September was the second best sales month of the year. We are gratified by the hard work of the sales and marketing team and the investment in our new customer relationship management system, Compass and are optimistic that it will make our sales force much more productive and effective in the future.

Some additional comments around our customer performance this quarter. On net churn, our bad debt and DSOs were all within historic norms. Our bad debt expense decline showed an improvement and shows the necessary nature of the service we sell our customers. We saw an acceleration in the number of customers that are choosing to pay us electronically versus paper checks as many of these customers have not fully returned to their offices. Overall, we believe that these statistics and the strong credit quality of our customer base and the importance of Cogent's services makes our corporate growth a continued trend in our business.

Cogent is the low-cost provider of Internet access and transit services and our value proposition to our Corporate and NetCentric customers remains unmatched in the industry. Our business remains completely focused on the Internet, IP connectivity, data centers and colocation services, all of which are necessary utilities for our customers. We remain optimistic about Cogent's unique position in serving small and medium-sized businesses in our on-net multi-tenant office buildings located in the central business districts of major cities in North America. These businesses are increasingly integrating data center architectures into their IT plans, making reliable, dedicated Internet access more critical than ever to these businesses.

We are gratified by how strong our customers' reactions have been to our superior service level and service qualities demonstrated by our Net Promoter Score of 65. Our Net Promoter Scores have historically been among the highest in our industry and continue to increase as a result of the criticality of our service and our prompt responses to customer concerns. Our multiyear constant currency long-term growth rate target is approximately 10% per year, and our EBITDA margin expansion rate of approximately 200 basis points a year.

Our Board of Directors has improved our 33rd consecutive increase in our regular quarterly dividend. The increase in our dividend and the rate of increase of our dividend by $0.025 per share sequentially to $0.73 per share per quarter. This represents a 14.1% annual growth rate in our dividend. Our consistent dividend increases and our continued optimism on the increasing cash flow generation of our business, drives our ability to grow returns of capital to shareholders. We believe that this drives the management team to be highly disciplined around the choices we make in capital allocation and how we grow our top line and manage our expenses.

In the quarter, we also purchased shares of our stock. We purchased $3.3 million of stock through the end of October 2020. As of October 31, we have $31.6 million remaining under our current authorization and buyback program, which is in place through December 2021.

We hope everyone on this call remains safe and healthy in these challenging times. We value the safety of all of our employees and continue to take all necessary precautions. We believe we are a net beneficiary of the current stay-at-home models that are being deployed around the world. And we are uncertain about the long-term implications of COVID on the macro economy. Our growth and profitability targets remain intact, and we remain committed to returning increasing amounts of capital to our shareholders on a regular basis.

With that, I'd like to open the floor for questions.

QUESTIONS AND ANSWERS

Operator^ (Operator Instructions)

Your first question comes from Phil Cusick with JPMorgan.

Phil Cusick^ Dave, can you just go again through your comments on September and October, you talked about really good sales momentum in September, what did you see in October? And then in terms of traffic growth as well, is that coming from big customers at lower prices? Or are you seeing that more like average price?

Dave Schaeffer^ Sure. Thanks for the question, Phil. We saw a reacceleration in sales activity, both in our Corporate and NetCentric business as customers return from their summer vacations, as they start to understand what their permanent IT requirements are going to be. We saw many Corporate customers begin to make decisions that maybe had been put on hold earlier in the pandemic, and we saw improvements in our sales efficacy of both the Corporate and NetCentric customers. Our NetCentric business is a volume-driven business. We saw a great deal of breadth in our growth and traffic, not from any one customer or even a handful of large customers, but a continuing broadening of our customer base.

Our traffic growth grew sequentially from September to October, 8%. That kind of mirrors the type of traffic growth acceleration we saw in March and April as the pandemic first hit. The key application that drives growth remains streaming. But we've seen the number of streaming providers grow dramatically the number of choices that are being offered, and that has broadened our customer base.

Secondly, with over 7,220 access networks buying access from us, we saw a significant improvement there in those access networks customers downloading traffic. And kind of overlying all of these trends is just the acclamation of the sales force to the changes that came about and deploying our new CRM system. With any change come some disruption, and that was probably more challenging in a remote environment than it would have been if our employees were physically in offices.

Our learning teams did a great job in training and helping those individuals understand the benefits of these new systems. And we're continuing to see the productivity improvement with actually record productivity in terms of calls made, e-mails made, opportunities created on a per capita basis. And with that, we expect to see an acceleration in our sales productivity numbers.

Just to remind investors, we don't report sales on bookings. We report sales numbers only upon the installation of services. So the lag of a few weeks to a few months for off-net will begin showing up in our fourth quarter sales productivity numbers.

Phil Cusick^ Can you just remind me quickly, what was the timing of when that new CRM system was implemented? And when -- and do you now think that everything is sort of normal?

Dave Schaeffer^ So it was implemented the first week in July, we did not want to disrupt the end of quarter and end of month sales in June. We migrated off of our previous CRM provider, which was a SaaS service. And the initial deployment actually went relatively smoothly, but because the new tools were more completely integrated into Cogent's other tools and systems, it really did take some retraining. And I would say in July and August, which are typically slow saleable months anyhow, we had this extra issue. By September, all of the issues related to that deployment have been resolved. And as I said, sales activities measured by these KPIs are at historically high levels now.

Frank Louthan^ Dave, it's Frank. I think your -- Great. All right. So a quick question on the buyback there. Have you made any purchases in Q4? And can you give us the average price in Q3 and your thoughts there? And the move on NetCentric revenue was good sequentially. Anything onetime in there or FX impact that we should know about?

Dave Schaeffer^ Yes. So let me take those in reverse order. First of all, we did not have any material FX impact in NetCentric, there was some impact, but not material. Second, there was no large order or any kind of onetime benefit. This was a broad participation of our customer base. Both small and large customers, access networks and content providers, and those trends have actually accelerated into the fourth quarter.

We reported on October's numbers, we're only a few days into November. But we continue to hit daily traffic volume, growth records. And as the majority of our footprint is returning to some kind of modified lockdown or shelter in place, particularly in Europe, we're seeing significant growth out of many of our access customers in those markets where those pandemic reactions are being deployed.

Now I'll pivot to the repurchase program. Our repurchases were relatively modest in the third quarter at an average price of just over $59 a share. We were more aggressive in our purchases in October, and we purchased at slightly over $56 a share. We continue to monitor the shares, and we do have a buyback. We're not going to comment on our current market activity just as our shareholders don't tell us when they're buying and selling. We want to have that same market advantage as we compound value for our shareholders.

Sean Wallace^ And just to clarify, we bought back $3.3 million, not shares, million dollars worth.

Dave Schaeffer^ Correct.

Frank Louthan^ Great. And one quick housekeeping thing. I assume your annual sales going to be virtual. Is there -- and I don't know that's usually a hit in the first quarter. Any thoughts on kind of a cost savings you might get from that for delta just for modeling purposes?

Dave Schaeffer^ Yes. So we have already concluded that for 2020, our sales meeting will be virtual. By adopting a virtual format, we're also going to be launching for the first time a customer sales event as well. So traditionally, our sales meetings have been exclusively internal. This year, because we are migrating to a virtual platform, we're actually going to have customers participate as well as salespeople, even with a much larger participation, we think we'll recognize probably about a $1.3 million, $1.4 million savings in the first quarter versus what we spent last year.

Operator^ Your next question comes from Colby Sinise with Cowen. You may ask your question.

Colby Sinise^ Two, if I may. First off, on sub trends, so whether it's on net or off-net, we saw a fairly notable deceleration in total net adds. In the third quarter versus really historical trend. Based on the productivity comments that you're speaking of that you're seeing already in the fourth quarter, can you give us some color on what we should anticipate for sub trends going forward? And then also the $9.5 million IRU payment also up notably versus what we typically see, I think you referenced maybe $2 million or so last year. How should we think about those going forward as you continue to look to expand the network? You mentioned South America, you mentioned Africa. How should we think about those IRU payments going forward since, obviously, at the end of data has some type of cash consequence?

Dave Schaeffer^ Yes, sure, Colby. A couple of different questions there. Let's take the unit productivity and sub trends. The primary drag on our business has actually been our off-net corporate sales. Our on-net corporate sales are slightly below trend line but pretty much still in line with historic averages. When we sell to a Corporate customer, the sale begins with an on-net sale. Those sales are continuing very well at primary locations. They've actually been bolstered by the fact that existing customers are migrating from 100 megabit to gigabit connections to support VPN work. And our new sales are almost exclusively 1 gigabit pulling our ARPUs up.

It is really the secondary locations that have suffered. Companies say, we don't have employees in those offices. We're not going to make any network decisions until we understand what our final real estate footprint will look like. As a result of that, we are selling less connections, both for Internet and VPN services, whether SD-WAN or VPLS to those secondary locations. Most of those are off-net. That is why our off-net revenue actually declined on a year-over-year basis. It did grow slightly in the quarter, but much below historic trends.

On average, we would typically grow our on-net and off-net Corporate sales at the same rate. We do also sell a few secondary locations off-net. Those have also slowed. That's why that growth rate has slightly decelerated. But in general, our Corporate on-net business is performing well. And actually, in this environment, far better than any other wireline provider. But it's that off-net problem that has really impacted our business.

And then pivoting over to our NetCentric customers, which by primarily on a metered basis, we're seeing a real acceleration in larger port sizes as those customers look to optimize cross-connect expenses in the nearly 1,300 data centers that we operate in and want to be able to support greater traffic volume. So we're seeing that broadly across our customer base. And our NetCentric sales force productivity is improving. And also our NetCentric revenues are improving, and we expect those trends to continue throughout this quarter as we monitor traffic now for 5 weeks into the quarter and seeing continued improvement. The overall effectiveness of the sales force is improving.

Now to pivot to your IRU question. We have continued to expand our footprint globally now we're in 47 countries. We purchased a significant additional dark fiber in two Latin American markets. Terrestrial dark fiber in Brazil to connect Rio and S‹o Paulo, the two largest markets as well as expanded our metro footprint in those markets. And we purchased significant additional dark fiber in Mexico to provide some new markets as well as now having three discrete border crossings, giving us much more diversity in and out of Mexico, as we have seen that market grow at an extremely high rate I think in large part, as a result of some of the deregulation that the Mexican regulator had implemented several years ago.

Sean Wallace^ Can I just add to that, Dave, we spent $6.1 million in the first quarter, $3.7 million in the second, obviously, went up to $9.5 million. We expect it will come back down into that range of $3 million to $6 million, we'll call it, $4 million to $5 million in the future. So that was as we expanded into those two Latin American countries. That was a bit of an anomaly.

Dave Schaeffer^ Yes. It was onetime.

Operator^ Your next question comes from Walter Piecyk with LightShed.

Walter Piecyk^ Dave, with the deceleration that's going on in the Corporate business, which has traditionally been pretty steady for you. I guess two questions. One, I mean, back in May, you thought that we could get back to historical averages, that's clearly not happening. When do you think that may happen? And if it doesn't happen, your leverage ratio has now gone up and is going up because you obviously increased the rate of dividend payments. So I'm just curious like if Corporate doesn't revert back to like a normalized growth rate, does it make sense to continue to grow the dividend like you are at this pace?

Dave Schaeffer^ Okay. So let me -- there are 3 questions there, and I'm going to take them in reverse order. We are absolutely committed to being efficient in returning capital and our dividend has been a very effective way to do that. Also, because roughly 50% of our dividend has been able to be characterized as a return of capital, we have aired more on dividends than buybacks. But Cogent has consistently returned more incremental capital each and every quarter to shareholders, and we feel that the 14.1% growth rate in dividend can absolutely be supported by the growth rate in our free cash flow.

The second point you raised was the change in our leverage ratios. And as we mentioned in the script, that was almost exclusively as a result of foreign currency translation. We elected not to hedge our EUR 350 million denominated debt. We chose to raise debt in Europe because it was a lower cost of capital, almost 100 basis points, less expensive than in the U.S. And because our European operations are profitable, we can service that debt and repay that debt out of European operations. So the optical increase in our leverage ratio was not as a result of incremental fruit at on a constant currency basis, but rather that $17.4 million swing that occurred in the -- a value of that $350 million debt, that's a non-cash and non realized loss for the quarter. And our bet is, over time, the euro will probably remain about where it is against the dollar.

Now to your very first question, which is corporate growth. The corporate growth has really been a tale of on-net and off-net. The on-net corporate growth rate is pretty close to being within long-term trend lines. We've averaged about 11% growth. We're probably around 9%. And considering the work from home environment and the impact of the pandemic, that's pretty impressive. It's really been the shortfall in off-net, which is secondary locations. I do believe companies are going through a bit of a real estate reevaluation. They will ultimately decide on what architecture is best for them.

But I do not believe that there will be a permanent exodus from U.S. cities, and our footprint will remain the core for our Corporate customers' real estate needs. We absolutely believe that our Corporate business should end up growing back at historic trends. But even if it doesn't, we have sufficient cash flow generation and our margin contribution is actually improving because our NetCentric business has a much higher percentage of on-net versus off-net than our Corporate business. So all in all, we're very comfortable with our ability to grow cash flow and continue to grow the dividend.

Walter Piecyk^ So you're saying in the third quarter, your on-net Corporate growth rate was 9% because that's I don't -- the math would be challenging to get to 1.3%.

Dave Schaeffer^ No. No. Since the beginning of the pandemic. So if you take --

Walter Piecyk^ Okay. But I'm just looking at the quarter, right? So thank you for the clarification on the euro. So right now, your Corporate business is growing at 1.3%. It was 10% only a couple of quarters ago. So I guess the question again is, if you can't return that to growth, and back in May, you thought you could return it back to that normalized growth and we stay at this 1% type of growth rate annually for Corporate, then notwithstanding any changes in currency, your leverage will rise to like 3.3 or 3.4. And I'm just in that scenario, does it make sense to continue to increase the dividend at this rate?

Dave Schaeffer^ So the answer is we will continue to increase the dividend. We have a leverage ratio that's between 2.5 and 3.5. So the 3.3 or 3.4 that you referenced is still within that guidance.

Secondly, we have consistently messaged to investors that we have a requirement to disgorge excess cash on our balance sheet. The only method to do that is either through accelerated buybacks or accelerated dividends. And as you saw in this last quarter, we took the opportunity to avail ourselves of both techniques.

Walter Piecyk^ So only if the leverage gets above 3.5 should we start to wonder whether maybe the dividend growth should not remain the way you have it set?

Dave Schaeffer^ I think that's right, Walt. And again, 3.5 is not set in stone. We have historically evaluated our leverage targets each and every quarter with the Board. Just to remind you, our initial leverage target was 2.5x when we first raised debt. And then when we breach that, the Board established the new guidance range of 2.5x to 3.5x. When we compare ourselves to other businesses with the durability of our revenue stream and the predictability of growth. Even in a very turbulent macro environment, we have substantially more borrowing capacity. And in a low interest rate environment, it may actually be beneficial to shareholders to continue to evaluate whether 3.5x is the right target. So I don't have an answer today because we're sitting here below the target range.

Operator^ Our next question comes from Michael Rollins with Citi.

Michael Rollins^ I was curious if you could update us on where your market shares are for the corporate and NetCentric business, how you look at the baseline opportunities to increase that over time? And then as you look at pricing in the corporate market, how do you view the durability of your price points for the different speed tiers that you're selling into the base?

Dave Schaeffer^ Yes. Sure, Mike. So with just under 1,800 multi-tenant office buildings on-net and 968 million square feet. We have 22.5 connections sold per building. It's down slightly from the 22.9% last quarter. We did add some new buildings late in the quarter with no customers. We do have typically sold about 1.5 connections per customer. Today, it's more likely we're selling closer to one connection because we're not selling very much in the way of VPN services. I think that will change.

The connections that are sold tend to be of higher speed. So we're selling gigabit at higher ARPUs and our ARPUs are going up. Also, our product is nonoversubscribed, nonblocked and symmetric. That has real implications for work-at-home employees as those ad hoc VPNs concentrated at a firewall need to have that level of symmetry and many of our competitors don't have products that can offer that type of service. Cable and telco have typically sold products that are symmetric in their services may have usage caps.

So for our Corporate customers, our 3 times greater reliability, 9 times faster install and better price performance and volume throughputs all give us, I think, a great deal of superiority. We also sell to our corporate customers on a limited basis, some off-net services and on-net buildings. You said, why would you do that? And it's customers wanting a backup service on a diverse network. And that's actually become more critical since the pandemic. No company wants its VPN concentration to be down. They realize that in that backup mode, they're going to be in a lower bandwidth operation but they are absolutely very interested in getting that network redundancy. So we are picking up some additional connections, not for VPN but for redundant off-net connections to on-net customers.

And then on the NetCentric side, the service is primarily metered, so you pay by the megabit. The port size does have a reservation fee associated with it, but the majority of the revenue is based on traffic flows and large reports mean fewer cross-connects and data centers and we're continuing to see a significant migration from 10 gigabit to 100 gigabit ports. We feel that we have more idled capacity in more data centers than any other provider in the world, and that's allowed us to gain market share. So in both our Corporate and NetCentric markets, we feel pretty good about our market share gains.

Operator^ Our next question comes from Nick Del Deo with MoffettNathanson.

Nick Del Deo^ First, Dave, you've expressed confidence that Class A office space would ultimately be okay as we got through the pandemic. I think you made a quick comment to that effect earlier in the Q&A. Has your thinking on that front evolved at all or become more nuanced, whether from a timing perspective or more fundamental factors?

Dave Schaeffer^ So I have to admit my thinking on the pandemic has evolved quite a bit over the 8 months that we've been living with this. First of all, I think the duration is going to be much longer. Yes, this is both me as an individual and my observations and talking to salespeople and customers. I don't think we're going to return to anything resembling normality for at least another year. If you would ask me that question back in April or May, I would have not expected a 18-month pandemic disruption to life.

Secondly, I believe that central business districts will continue to house businesses. And the skyscrapers in which we operate will continue to have substantially higher occupancy rates than they previously did. As a result of lower rents, tenants will tend to migrate from more marginal buildings into better buildings. The majority of our footprint about 59% are lead certified. The buildings are on average nearly 50 times the national average. I think many of the equity owners of those buildings may get wiped out, but the buildings won't disappear.

I also think the work habits are going to change. We're going to go to a hybrid model where some employees, some days at a week will work remotely. Secondly, I think the shared office model, probably will not return anywhere like it was a year ago with the growth of companies like Regus and WeWork. Third, I think the offices will typically be doored offices, requiring more square foot per capita and less open floor plans. So I think the aggregate usage per employee will actually go up.

You won't have as many employees in the office as many days of the week, but the offices will still remain in business. Like I was sharing with one customer, I said, it's really hard for a law firm to bill $2,000 an hour when the partners in home and is employees really do want to come into an office and occasionally meet and transact business.

The final piece that I don't have great clarity on is what happens with branch offices. Those branch offices fall into 2 categories. Those that are in separate cities. I think those will continue. A law firm is headquartered in Cleveland, at his offices in Chicago and Philadelphia, that's going to still be required. What may not be required is a company that has an office in Downtown Manhattan and satellite offices in Stamford, Connecticut, in Morristown, New Jersey, to accommodate partners who maybe did not want to commute in.

I think in those cases, you will see consolidation of offices and you will see the hybrid work-from-home model. So the answer is, my thinking has evolved. It probably will continue to evolve. I think there's still a lot of unknowns, including when we'll have adequate vaccines, distribution and when even therapeutics will be sufficiently robust that people will return to life as normal. I mean, we're just not there yet.

Sean Wallace^ Can I just add some to Dave's color, Nick. If we look at our multi-tenant office buildings, these 1,800 buildings we talk about and we look at direct Internet access connections. If the world of direct central business offices was declining, we would see an acceleration in churn in those buildings for those type of circuits. And indeed, the churn has actually gone down in a couple of months.

So yes, as we mentioned, corporates are delaying decisions and not deciding to do things now. We're seeing normal levels of churn but we don't see a material change in the number of tenants in those buildings. We do see discussions from commercial brokers where law firms who might be in 3 floors might go to 2 floors, I think we'll benefit from that. This trend indicates there will be more available space and potentially be more tenants. We won't really see any change in that until the pandemic is over and people sort of return to normal soon.

Nick Del Deo^ Got it. I don't want to drag the call out too much. But Dave, I thought the comment you made regarding off-net locations in different metro areas versus within the metro area was interesting. Is there a way to size what share of your off-net corporate connections would be in fall into one category versus the other?

Dave Schaeffer^ So we obviously have data on where those nearly 12,000 connections are 11,900. They're in approximately 6,800 buildings. I would say the majority, greater than 50% are in different MSAs or markets. But there is a significant minority that operate within a given MSA as well. So we do have exposure there. I'd be lying if we didn't, and that's really where the pain has been.

Operator^ Your next question comes from Tim Horan with Oppenheimer.

Tim Horan^ Great. So just following the previous questions thread, Dave. So I guess the million-dollar question is will we see churn pick up in these Class A office spaces next year because of COVID or people just deciding, look, I don't want to be in these downtown areas anymore 1 out of here or if that will happen or not. Yes, obviously, if that doesn't happen, it's very good for your business. But I hear you on a bit, but it's not going to be the 12, 18 months, maybe some people just gave up on those leases and move out as a question, I guess.

Dave Schaeffer^ Yes. And I wish I had the answer to that question. I'm also going to answer the question with my experience as a central business district landlord, I actually am continuing to sign new leases in downtown space. I signed about a new lease a week in my portfolio. I mean, that's anecdotal evidence. I do think companies are rethinking how their workforce is going to be housed. And I do think there will be some permanent work from home, but I think it will be more on a flex basis.

I just was talking to customers who do not see how a large law firm can function without, say, an office. If, in fact, a law firm shrinks its footprint, that can actually be a net positive for us because it increases the number of discrete tenants in a building. Our average customer today is housed in about 8,000 square feet and has 30 desktops. Now clearly, we have some very large law firms that have 10 floors in a building and 3,000 or 4,000 desktops. If they end up going to half of that footprint, that's probably a net positive for us. I just don't see people totally abandoning cities.

There will be a shift but a lot of individuals voluntarily chose an urban life style and much business still depends on physical contact and interaction. We're making doing a pandemic. We're getting by with social distancing and Zoom conferences. But I know in talking to customers, one of the common refrains I had here is, I'm Zoom exhausted. I can't wait to get back to my office. So again, this is all anecdotal feedback, but I think rents will come down. There will be increased competition. There will be turnover in the ownership of these assets, but I just don't see, say, the New York or San Francisco or Chicago skylines going dark.

Sean Wallace^ Can I just add one thing to Dave's insight is we spent time with Jones Lang LaSalle which has a research group that surveyed 100 commercial tenants in the Midwest. These are businesses that are in place like Chicago and Pittsburgh and Minneapolis. Of these 100, 95 said they're not leaving that central business district. 5% said they don't know. They're not sure. Zero said they're leaving.

We service 95 of the 100 largest law firms in the United States. It's very difficult for a law firm to be successful if they aren't near their clients. These knowledge intensive workers need to be in CBDs This is where there clients and vendors are. Our small to medium-sized business clients of knowledge workers who are in consulting firms, accounting firms, law firms: these are the folks who have to be in central business districts. And we -- again, we haven't seen any uptick in our churn in multi-tenant office buildings of these direct Internet access ports, which are the like of that intra infrastructure for those types of companies.

Dave Schaeffer^ And I'll close on one comment. I was talking to a partner in one of our customers. And he said, one of the greatest challenges is how do they train and attract new talent in a remote environment. We figured out in Cogent for a telesales organization. That's a much different training curve than a partner track at a white shoe law firm or a partner track at a McKinsey or a Bain or a BCG. I mean those young, very smart individuals need the mentoring in person of senior partners, and that's not going away. So we will get through this. My thinking has evolved. It is taking longer, but we will return to something that resembles the life we did before the pandemic. It happened in 1918, and it's going to happen again.

Operator^ I'm showing no further question at this time. I would now like to turn the conference back to Mr. Dave Schaeffer.

Dave Schaeffer^ I want to thank everyone. Please stay safe, social distance, wash your hands, wear a mask. Those aren't political statements. Those are good hygiene. And feel free to reach out to Sean or myself, if anyone has any questions. I would normally say look forward to seeing you on the conference circuit, but now I look forward to talking to you on the conference circuit. Take care, everyone.

Operator^ Ladies and gentlemen, this concludes today's conference. Thank you for your participation, and have a wonderful day. You may all disconnect.