Cogent Communications, Inc. (CCOI)

DAVE SCHAEFFER founded Cogent Communications, Inc., in August 1999 and is the Chief Executive Officer. Prior to founding Cogent Communications, Mr. Schaeffer was the Founder of Pathnet. He also developed a regional paging carrier and numerous SMR systems throughout the United States. Mr. Schaeffer has founded and operated a total of seven successful businesses, including the second-largest delivery and ground transportation enterprise in the United States, and a property and casualty underwriter. Mr. Schaeffer has also developed 46 commercial real estate properties in the Washington, D.C., metro area. Mr. Schaeffer holds a B.S. in physics from the University of Maryland, where he was also a Ph.D. candidate in economics.

SECTOR — TELECOMMUNICATIONS

(AYB603) TWST: Please give us an overview of Cogent.

Mr. Schaeffer: Cogent is a provider of dedicated Internet access service. We operate a network that stretches from Seattle, Washington, around the world to Kharkiv in the Ukraine from Helsinki, Finland, to Mexico City; 57,500 miles of intercity fiber that is then connected to an additional 27,200 miles of intracity or metropolitan fiber in 185 markets around the world. On that network, we are solely built to carry Internet traffic, so we are running IP directly over DWDM connected to user locations and data centers in about 1,400 skyscrapers in North America and about 700 data centers around the world. We sell Internet connectivity on that network.

TWST: Is the network physical fiber?

Mr. Schaeffer: Yes, it's physical fiber, and then on that fiber we are running wave division multiplexing equipment. Think of it as a prism, and we're running multiple colors on a single strand of fiber. On each of those colors, we are transmitting 10 gigabits of throughput or data across the network. It is physical fiber into the data center, into the office building and stretching around the world. Then on that fiber, we are today dividing it into 160 unique colors, if you will.

TWST: Can you explain the relationship between wireless and your networks?

Mr. Schaeffer: We sell to a number of wireless carriers globally. We ourselves are a wired or fixed-line network, but we have hundreds of wireless carriers who buy their upstream connectivity from Cogent. We also serve about 20,000 corporate users, and oftentimes3 those corporate users put Wi-Fi in their offices or at the end points of the network so they then can have wireless inside of their own location. Today, while wireless is fast-growing, it is still a very small percentage of the total Internet traffic globally. It's likely less than 1% of global traffic.

TWST: Is it accurate to say that wireless is not your primary priority at this time?

Mr. Schaeffer: That's correct. The majority of our business comes from selling to either corporate end users or very large service providers. Our business is really divided into two addressable markets. 52% of our revenues come from our corporate end-user business. 48% comes from our service-provider business, and that service-provider business is equally divided into two large subgroups — roughly half of it is regional access networks, wireline or wireless, and the other half is large content publishers such as Apple or Netflix.

TWST: When you talk about your corporate customers, what are the characteristics you are looking for? Is it a company that has a large amount of content it wants to push over the network?

Mr. Schaeffer: Our corporate business is actually to end users that are relatively modest in bandwidth consumption. These include companies like law firms or financial services companies, engineering firms, that kind of company. That accounts for 52% of our revenues. And the most common product that we sell in that market segment is a 100-megabit non-block to non-oversubscribed Internet connection. And then, for our large users — which are other networks — they are buying hundreds of gigabits of bandwidth from us in one of 700 carrier-neutral data centers around the world.

TWST: And so you've talked about the corporate being 52% and wireless being very small; where do you see your largest market opportunity at this time?

Mr. Schaeffer: We have two discrete addressable markets, and we actually have a lot of opportunity in each of those markets. On the service-provider side of our business, we today carry about 20% of the world's traffic; that means 80% goes somewhere else. We are generating about 12% of the dollar spent on Internet connectivity and data centers. So we have a significant opportunity to grow that business.

Secondly, on the corporate side, we are connected into 1,400 skyscrapers. Within those buildings are 51 potential customers. Today, we average 11.5 customers per building. So it means roughly 39 businesses in each of those buildings are not buying from Cogent today. That gives us a large untapped market in both segments of our business.

TWST: What pricing trends are you seeing, and how are those trends impacting your operations?

Mr. Schaeffer: We have always been known as the price leader in the industry. On the corporate side, we are typically competing against the incumbent phone companies, and we deliver 65 times as much bandwidth to the end-user customer as the incumbent does for the same price point. On the service-provider portion of our business, we are the lowest-cost provider, and we guarantee to undercut our competitors by 50%. In that business segment, the average price per megabit has been declining annually at about 23% per year. The unit volume for Cogent is growing about twice as fast as that of the market, for us growing at about 57% year over year.

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TWST: What is happening overall in terms of data usage, and how does that impact Cogent?

Mr. Schaeffer: We are seeing two major trends happening in the space. First of all, the Internet is cannibalizing every other telecommunication service and product; everything is moving to the Internet. Voice is going over the top in VoIP, video is going over the top, and people are turning off linear video channels to replace them with on-demand using the Internet. That is driving unit volume growth, but because of technological advancement, price per bit continues to fall. So the first trend is this kind of product-substitution trend.

The second key trend in our industry is video. The Internet is becoming the primary mechanism to deliver video, whether it's Netflix or Google or Fox or Apple or Amazon, they're all using the Internet as a way of allowing customers to stream content. And that will continue for at least the next half a dozen years and will be the key driver of unit volume growth. We see those as the two major trends happening right now in the telecommunications space overall.

TWST: How do these trends impact you — both the product substitution and the video?

Mr. Schaeffer: They are both positives for us for two reasons. One, we don't have a legacy business that's being eroded or substituted away. Anything that causes growth in the Internet is a positive for us. In fact, our corporate business has grown organically sequentially for 36 consecutive quarters as a public company at an average growth rate of 3.3%. Our service-provider business has grown at an average of 2.7% sequentially quarter over quarter. So we have been able to grow revenues because of these two trends.

We also have the best cost structure in the industry, which has allowed us not only to sell at the lowest price but to have the highest cash flow conversion. We have been fortunate in that we have been producing free cash from operations for eight years. We pay a dividend, and we have grown that dividend every quarter sequentially since issuing it.

TWST: What is your growth strategy, and where do you plan to focus over the next few years?

Mr. Schaeffer: Here at Cogent, we grow our business three ways. The primary driver of growth is better sales execution, more sales people, more productivity per individual, and we have been aggressively expanding our sales organization. The second is to add more buildings to our network, so therefore we have more addressable market available to us. We continue to do that, adding over 130 buildings last year. And then third, we do look at new regions or areas to expand our network. We operate physically in 38 countries, and we constantly look at other markets to see if they justify us expanding. All of those grow our business and our bottom line.

TWST: Are you anticipating major expenditures in the near future, and if so, where will those be focused?

Mr. Schaeffer: Expanding our network does require capital expenditure. However, capital budget has continued to decline for the past three years. And while we're investing in our business, in the sales force, in new buildings and new routes, we do anticipate continuing declining capital intensity which should allow us to continue to accelerate our free cash flow generation and return of capital to shareholders.

TWST: In May, you announced a new holding company structure. Why did you decide to make that change, and has it had any impact on your actual operations?

Mr. Schaeffer: In May, we did do a corporate reorganization. The purpose of that was to allow us to take capital that we had accrued in our restricted payment basket under our senior secured debt and make that capital available to our equity holders, either for buybacks or dividends. So it was a restructuring in order to accommodate the constraints of our covenants under our senior secured debt instrument. But there was no operational impact on the business.

TWST: And also in May, you announced your first-quarter results. What contributed to your increase in revenue this quarter?

Mr. Schaeffer: We grew sequentially 3.5% on a constant currency basis, which was an extremely strong quarter. Our margins continue to expand, and we were able once again to raise our dividend. And also during the quarter, we reported that we had bought back stock both in the first quarter and the first part of the second quarter up until the earnings call, and we had bought back about $28 million worth of our stock. So I think, operationally, we were very pleased. We had more sales people; we grew the sales force to 317 quarter bearing reps. Those reps were roughly 30% more productive than our average sales force productivity at 5.9 orders installed per rep. And our revenue growth accelerated substantially from 2.5% to 3.5% sequentially.

TWST: On the other side, what were the challenges for you in the quarter that you felt you would like to improve?

Mr. Schaeffer: There is always a challenge in our sales organization, and we are constantly trying to improve our cost of revenue acquisition as well as making sure we have enough sales people to adequately address our potential customers. So I would say the biggest challenge for Cogent in the quarter, and really throughout our nine year history as a public company, has been to be able to hire, train, incent, retain and promote sales people. This is a very tactical challenge but a very significant one, and it's one we constantly work on.

TWST: You have talked a little bit about the dividend and the fact that you not only have historically paid one, but that it's increased sequentially. Why do you choose to pay the

dividend, and do you see that staying steady going forward?

Mr. Schaeffer: The purpose of any business is ultimately to generate free cash flow for its stakeholders. In our case, we have much less leverage than other companies in our sector moving about 1.8 times net levered. We are investing as rapidly as we can in the underlying business, and yet, we are still generating excess cash. So we have told investors that over the next 10 quarters we will increase our net leverage from 1.8 to 2.5 times EBITDA, and we will consistently grow our top line 10% to 20% and expand EBITDA margins by at least 200 basis points. The combination of that gross margin expansion and leverage means that we will return about $10 a share to shareholders over the next 10 quarters, and a dividend is an important part of that mechanism of capital return.

TWST: What are your revenue margins like right now, and are they where you would like them to be?

Mr. Schaeffer: Our EBITDA margins are 35%; our gross margins are about 58%. Both of those are going to continue to improve. In fact, over the past nine years, we have averaged 220 basis points a year of EBITDA margin expansion. We expect those trends to continue, and we've guided investors to expect at minimum 200 basis points of EBITDA margin expansion this year, next year and the year after that. So we clearly have a business that has substantial operating leverage. We have delivered 48.5% EBITDA contribution margins over the past nine years.

TWST: Tell us about your background and then about the rest of your management team.

Mr. Schaeffer: We have a very stable management team. We have been in place for a long time. Many of my colleagues have been with us since the beginning of the company. I'm a bit of a serial entrepreneur; this is the seventh company I've founded, and I've taken other companies public. And we are very committed to using our network, our asset base to continue to return capital to shareholders, which I think, rewards all of us in the form of an appreciating stock price.

TWST: Cogent is often ranked in the top five networks in the world. In your opinion, what are your strongest competitive advantages, and what keeps you ranked up there?

Mr. Schaeffer: It's really interesting; for the size company, we are doing about $400 million in revenue when compared to others that are ranked above us doing literally hundreds of billions of dollars in revenue. Our network is in many cases larger by a number of metrics. What really makes us special is our business model. We started in 1999 with three simple premises: One, the Internet was going to be only network that would eventually matter. Two, utilizing wave division multiplexing, Ethernet and optical interface routing, we could drive down cost by at least two orders of magnitude. And three, what we sell is a commodity, and we need to win business based on price. Those three tenants have allowed us to become the second-largest carrier of Internet traffic in the world, carrying about 20% of the world's traffic on our network.

TWST: Thank you. (LMR)

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