Cogent Communications Holding

Q3 2022 Earnings Conference Call

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PRESENTATION

Operator

Good morning, and welcome to the Cogent Communications Holdings Third Quarter 2022 Earnings Conference Call.

As a reminder, this call is being recorded, and it will be available for replay at www.cogentco.com. A transcript of this conference call will be posted on the same 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 like to turn the call over to Mr. Dave Schaeffer, Chairman and Chief Executive Officer of Cogent Communications Holdings.

David Schaeffer

Thank you, and good morning everyone. Welcome to our third quarter 2022 earnings conference call. I'm Dave Schaeffer, Cogent's CEO. With me on this morning's call is Tad Weed, our Chief Financial Officer.

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Hopefully, you've had a chance to review our earnings press release. Our press release includes a number of historical metrics that we present in a consistent manner for every quarter.

Our revenue growth accelerated this quarter, and our corporate revenues increased sequentially by 4/10 of one percent from the first quarter, the first time since the beginning of the pandemic, and is in part due to the increase in USF revenues. Excluding the $670,000 sequential increase in USF revenues, our corporate revenues were essentially flat sequentially for the quarter.

Our total revenues increased sequentially by 1% to exactly $150 million, an increase of 1.4% year-over-year. Our total revenues and our NetCentric revenues were materially impacted by the negative impact of foreign exchange in the quarter and the continuing strengthening of the U.S. dollar. For the quarter, the sequential negative impact of foreign exchange was $1.5 million and was negative $4.2 million on a year-over-year basis. On a constant currency basis, our revenues grew sequentially by 2% and grew by 4.3% year-over-year.

Our corporate business continues to be influenced by real estate activities in the central business districts of major North American cities. Two key statistics, including the level of security card swipes in buildings and leasing activities indicate that year-to-date, the real estate market and leasing activities in the central business districts have seen some improvement but have not yet returned to their pre-pandemic levels. Leasing activity across major markets and workers return to offices continue to improve, albeit slowly.

On a U.S. GAAP basis, our corporate revenues increased sequentially 4/10th of a percent for the first time since second quarter of 2020. We continue to remain cautiously optimistic in our outlook for improvement in our corporate revenues in these uncertain economic times and continuing to deal with the challenges of COVID-19.

Our NetCentric business continues to benefit from continued growth in video traffic and streaming. For the quarter, our network traffic was up 2% sequentially, and traffic accelerated to a year-over-year growth rate of 21% in the third quarter. On a U.S. GAAP basis, our NetCentric revenues grew sequentially by 1.9% and grew by 9.6% on a year-over-year basis. On a constant currency basis, our NetCentric revenues grew sequentially 4.3%, an increase by 16.8% from the third quarter of 2021.

Our EBITDA margins, as adjusted for the $2 million extraordinary expense associated with the acquisition of T-Mobile Wireline, also known as the Sprint's GMG business, that were incurred in the quarter, increased sequentially by 50 basis points and by 90 basis points on a year-over-year basis to 39.9%. This EBITDA margin represents the highest Adjusted EBITDA margin in the Company's 23-year history.

Our salesforce rep productivity was 4.6 units per rep per full-time equivalent as compared to 4.9 in the last quarter. While this is a decline of 6.1%, it still represents a 7% year-over-year improvement. We significantly increased the size of our salesforce by adding 45 sales reps, a 9.4% sequential increase, representing the largest ever net increase in salesforce in Cogent's history. This did impact our rep productivity. We entered the quarter with 522 reps and 465 full-time equivalents, a 3.6% increase in full-time equivalent sales reps.

Now for a couple of words on the acquisition of the Sprint Wireline business. We are diligently working through the approval process to complete our acquisition of Sprint's Wireline business in conjunction with T-Mobile and numerous various regulatory agencies around the world. We anticipate the acquisition will close in the second half of 2023. We incurred $200 million of professional fees in the third quarter in conjunction with the acquisition. We anticipate those professional fees to be dramatically reduced in the subsequent quarters.

We anticipate that the Sprint Wireline revenues, that were approximately $560 million for Fiscal Year 2021, will be approximately $450 million annual run rate at the close date. We expect that the number of

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Sprint Wireline products will be reduced dramatically from the approximately 30 products offered today down to four by closing.

Over the next three years, we anticipate annualized savings of $180 million on the North American network primarily by utilizing the Cogent metro footprint and our on-net building portfolio. We also anticipate $25 million of annual savings on the international network by migrating off of a leased network on to the owned Cogent network globally. We thirdly expect about a $15 million reduction in Cogent's operating and maintenance expenses associated with an IRU that we will be abandoning. There will be additional SG&A savings that include headcount reduction and other general operating cost synergies.

During the quarter, we returned $42.7 million to our shareholders through our regular dividend program. We did not purchase any stock during the quarter and have $30.4 million available under our buyback program, which the Board extended to 2023. Our Board of Directors, reflecting on the strong cash flow generating capabilities, investment opportunities in front of the Company, decided to increase our quarterly dividend sequentially by $0.01 per share, raising our quarterly dividend from 90.5% per share to 91.5% per share. This increase represents the 41st consecutive sequential increase in our regular quarterly dividend. A 4.4% annualized dividend growth rate is now in line with our growth rate and free cash flow generation.

Now for a couple of comments around long-term expectations. Our targeted long-term EBITDA margin expansion and guidance is for approximately 200 basis points per year. Our targeted multiyear constant currency growth rate is targeted to be 10%. Once our entities, that is Cogent and Sprint are combined, we anticipate that for the combined entity, the annual revenue growth rate will be between 5% and 7%, and the EBITDA margin expansion annually after initial synergies are achieved will be about 100 basis points per year. Our revenue and EBITDA guidance targets are intended to be multiyear targets and are not intended to be used for either quarterly or even specific annual guidance.

Now, I'd like to ask Tad to read some Safe Harbor language, provide some additional operating performance data, and then, after that, we will open the call for questions and answers.

Thaddeus Weed

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 the 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'll find these reconciled to the corresponding GAAP measurement in our earnings releases, which are posted on our website at cogentco.com.

Comments on COVID-19 and risk updates. Like many companies, we continue to be impacted by the COVID-19 pandemic, and our risks related to COVID-19 and other risks are described in more detail in our annual report on Form 10-K for 2021 and in our quarterly reports on Form 10-Q for the first and second quarter and this quarters report which will be filed Friday.

Corporate and NetCentric revenue and customer connections. We analyze our revenues based upon network connection type, which is on-net, off-net, and noncore, and we also analyze our revenues based upon customer type. We classify all of our customer into two types: NetCentric customers and corporate customers.

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Our corporate customers buy bandwidth from us in large multi-tenant office buildings or in carrier-neutral data centers. These customers are typically professional service firms, financial service firms, educational institutions located in multi-tenant office buildings or connected to our network through our carrier-neutral data center footprint.

Our NetCentric customers buy significant amounts of bandwidth from us in carrier-neutral data centers and include streaming companies and content distribution service providers, as well as access networks who serve consumers and business customers.

Our corporate business represented 57% of our revenues this quarter. Our corporate revenue declined year-over-year by 4% to $85.5 million from the third quarter of last year but, as Dave mentioned, increased sequentially by 0.4% for the first time since the second quarter of 2020. We had 45,176 corporate customer connections on our network at quarter end, which was a sequential increase of 0.25% and a year-over-year decline of 0.8%.

Our total revenues and our corporate revenues are impacted by changes in the USF tax rates, which are updated quarterly. For the quarter, the impacted USF on our revenues was a positive $0.7 million, and the impact was negative year-over-year by the same amount $0.7 million.

Our NetCentric business, which represented 43% of our revenues in the quarter, and despite very material FX headwinds, had another solid quarter and grew by 1.9% to $64.5 million sequentially and grew by 9.6% on a U.S. GAAP on a year-over-year basis.

Volatility in foreign exchange rates primarily impacts our NetCentric revenue, and the impact was materially negative both sequentially and year-over-year. On a constant currency basis, our NetCentric revenue increased year-over-year by 16.8%, which was an increase from the constant currency revenue increase last quarter of 16.2%, and grew sequentially by 4.3%, which also was an increase from last quarter, which was 2.5%. We had 51,145 NetCentric customer connections on our network at quarter end. That was a sequential increase of 0.9% and a year-over-year increase of 7.8%.

On revenue and customer connections by network type. Our on-net revenue was $113.2 million for the quarter, which was a sequential increase of 1.1% and a year-over-year increase of 1.9%. Our on-net customer connections increased by 0.4% sequentially to 82,614 and increased by 3.1% year-over-year. We serve our on-net customer connections on our network in our 3,126 total on-net multi-tenant office and carrier-neutral data center buildings. We continue to succeed in selling larger connections, 100-gigabit 400-gigabit connections in selected locations, and that has had the impact of increasing our on-net ARPU.

Our off-net revenue was $36.6 million for the quarter. A sequential increase of 0.9% and a small year-over-year decrease of 0.1%. Our off-net revenues are impacted by incorporating the cost savings we obtain from lower local loop prices into our pricing. The introduction of these customers into our off-net revenue base lowers our off-net ARPU. Our off-net customer connections increased sequentially by 1.5% to 13,359 off-net connections, that was a 6.9% year-over-year increase. We ended the quarter serving our off-net customers in about 8,100 off-net buildings. These off-net buildings are primarily located in North America.

Our average price per megabit of our installed customer base decreased for the quarter, and our average price per megabit for our new customer contracts was flat. The average price per megabit for our installed base declined sequentially by 6.3% to $0.27 and declined year-over-year by 20.8%. The annual rate of this annual rate of decline was better than our historical long-term rate of decline for our installed base of 21.5%. The average price per megabit for our new customer contracts for the quarter was $0.15. That

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was the same as last quarter and a year-over-year decline of 24.2%. This annual rate of decline that was compared to our long-term rate of decline of 22.1%.

Selling larger connections results in a change in our connection mix and has the effect of lowering our average price per megabit at a greater rate than changes in our ARPU. Our on-net ARPU slightly increased, and our off-net ARPU continued to decline, but at a slight rate from lower pricing we are obtaining from our off-net circuit vendors that we passed on to our off-net customers.

Our on-net ARPU, which includes both corporate and NetCentric customers increased sequentially by 0.5% from $455 to $458. Our off-net ARPU, which is predominantly comprised of corporate customers, climbed sequentially by 0.8% from $927 to $920.

Some comments on churn. Our sequential quarterly churn rates for both on-net and off-net connections were relatively stable, and they continue to hover around 1%. Our on-net unit churn rate was 1.1% this quarter compared to 1% last quarter, and our off-net unit churn rate was 1% this quarter and 1.1% 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 service with us. 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 Cogent contract.

During the quarter, certain of our on-net customers—NetCentric customers took advantage of our volume and contract term discounts and entered into long-term contracts with us for over 2,350 customer connections, and that increased their total revenue commitment to Cogent by $21.5 million.

Some comments on EBITDA and EBITDA margin. We reconcile our EBITDA to our cash flow from operations in each of our quarterly earnings releases. Seasonal factors that typically impact our EBITDA and our SG&A expenses, in particular, 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 level of our audit and tax services and more recently Sprint acquisition costs and our annual benefit plan cost increases.

Our EBITDA, if you include the $2 million of Sprint acquisition professional fee costs, decreased sequentially by $0.6 million and increased slightly year-over-year by $0.1 million. Our EBITDA, excluding the Sprint acquisition cost, increased sequentially by $1.4 million and $2.1 million year-over-year. The negative impact of foreign exchange reduced our year-over-year EBITDA growth by $1.8 million. Our quarterly EBITDA margin, including the Sprint acquisition costs decreased sequentially by 80 points to 38.6% and year-over-year by 40 basis points. Our quarterly EBITDA margin, excluding the $2 million of Sprint acquisition costs, increased sequentially by 50 basis points to 39.9% and increased year-over-year by 90 basis points.

Comments on earnings per share. We did incur a net loss this quarter due to the $16.9 non-cash increase in the valuation of our swap agreement, and our basic and diluted loss per share was $0.17 for the quarter. Foreign exchange gains and losses on the translation of our 2024 euro notes into USD until we extinguished them on June 30, 2022. Losses on the extinguishment of debt and the non-cash changes in the valuation of our interest rate swap agreement have been the primary contributors to the variability in our net income and, consequently, our per share results.

Further comments on foreign currency. Our revenue earned outside of the United States is reported in U.S. dollars and was approximately 24% of our total quarterly revenues this quarter. About 16% of our revenues this quarter were based in Europe, and 8% of our revenues were related to our Canadian, Mexican, Asia-Pacific, and South American and African operations.

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As we experienced again this quarter, volatility in foreign exchange rates can materially impact our quarterly reported U.S. GAAP results. The foreign exchange impact on our revenue this quarter was materially negative both sequentially and year-over-year, and it's expected again to be materially negative in the fourth quarter.

The average Euro to U.S. dollar rate so far this quarter—so our fourth quarter is $0.98, and the average Canadian Dollar exchange rate is $0.73. Should these average foreign exchange rates remain at the current levels for the remainder of the fourth quarter of this year, we estimate that the FX conversion impact on our sequentially quarterly revenues for the fourth quarter would be a negative $1 million, and the year-over-year conversion impact on our quarterly revenues would be a negative $4.3 million.

We believe that our revenue in customer base is not highly concentrated, and our top 25 customers represent about 6% of our revenues for the quarter, consistent with the past.

Some comments on Capex. Our quarterly capital expenditures did increase sequentially to $24 million. Supply chain uncertainties and purchases in anticipation in the closing of our Sprint acquisition have caused us to shift our typical purchasing schedule for network equipment. These anticipatory investments are designed to ensure that we have satisfactory inventory levels of network equipment to accommodate our growth plans, and that includes our new wave-length product offering as a result of the Sprint Wireline acquisition and the interconnection of our two networks together in multiple locations and to meet our Cogent customer needs.

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 IRU finance lease obligations were $287.9 million at quarter end. We have a very diverse set of IRU suppliers and have IRU contracts with 306 different dark fiber suppliers across the world.

Cash and operating cash flow. At quarter end, our cash and cash equivalents and restricted cash as $323.7 million. Our $54.7 million of restricted cash is directly tied to the estimated fair value of our interest rate swap agreement as collateral. Our cash flow from operations was $53.6 million this quarter and a Cogent record, and an increase of $6.2 million from the third quarter of last year, and a significant increase of $19.2 million from last quarter.

Some comments on debt and ratios. Our total gross debt at par, including finance IRU lease obligations, was $1.2 billion at quarter end, and our net debt was $914.2 million. Our total gross debt to trailing last 12 months EBITDA as adjusted for our Sprint acquisition costs ratio was 5.31% at quarter end, and our net debt ratio was 3.93%. Our consolidated leverage ratio, as calculated under the note indentures, was slightly different, 5.30%, and our secured leverage ratio was 3.37%. Our fixed coverage ratio, as calculated under our note indentures was 3.9%.

Some comments on the swap. We are party to an interest rate swap agreement that modifies our fixed interest rate obligation associated 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 the 2026 notes. We record the estimated fair value of the swap agreement at each reporting period, and we incur corresponding non-cash gains or losses due to the changes in market interest rates.

At quarter end, the fair value of the swap agreement increased by $16.9 million from last quarter to a net estimated liability of $54.7 million. We are required to maintain a restricted cash balance with the counterparty equal to the net estimated liability. The settlement payments under our swap agreement are made in November and May. Our initial settlement payment that was made in November of last year was a net cash savings of $0.6 million. Under the settlement payment made in May of last year, we achieved a net cash savings of $1.2 million for the period from November 2021 to April 30, 2022. That was a total

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combined savings of $1.8 million for those two payments. Under the settlement payment that we are making on November 03, will be a net cash interest expense of $3.4 million for the period from May 1 through October 31.

Lastly, some comments on bad debt and DSO, which both improved. Our bad debt expense was only (audio interference) of our revenues for the quarter, unchanged from last quarter, but a significant improvement from 0.7% the third quarter of last year. Our days sales outstanding, or DSO, for worldwide accounts receivable improved and was 21 days, improved by one day from 22 days last quarter.

Again, excellent collection activity results. We want to thank and recognize our worldwide billing and collection team members for continuing to do just a fantastic job serving our customers and collecting from our customers.

With that, I will turn the call back over to Dave.

David Schaeffer

Okay, thanks, Tad. I'm going to highlight a few of the strengths of our network, our customer base, and our salesforce.

Now, for a couple of comments on our NetCentric performance. We achieved excellent revenue growth in our NetCentric business. Our year-over-year NetCentric revenue growth was 9.6% and was 16.8% on a constant currency basis, an acceleration from the 16.2% constant currency growth that we delivered in Q2. We are direct beneficiaries of an increasing trend of over-the-top video and streaming, particularly in international markets.

At quarter's end, there were 1,433 carrier-neutral data centers connected to our network, 54 Cogent data centers for a grand total of 1,487 data centers, more than any other carrier as measured by independent third-party research. The breadth of our coverage enables our NetCentric customers to better optimize their networks and reduce latency. We expect that we will continue to widen our lead in this market as we project to add over an additional 100 carrier-neutral data centers to our network each year for the next several years.

At quarter's end, we were directly connected to 7,766 networks that comprise the majority of the Internet. This collection of ISPs', telephone companies, cable companies, mobile operators, and other carriers provide us access to the vast majority of the world's broadband and mobile subscriber customers.

At quarter's end, we had a salesforce of 208 sales professionals who focused exclusively on the NetCentric market. We believe this salesforce is one of the largest and most sophisticated sales team for this market segment in the industry.

Now, for a couple of comments on our corporate business. We are seeing some positive trends in our corporate business. As work-from-home environment becomes established as part of people's normal work routines, we see many of our corporate customers looking to upgrade their Internet access infrastructure to larger capacity connections.

Our corporate customers are aggressively integrating new applications which have become part of the work-from-home environment, including video conferencing. This usage will require high-capacity connections both inside and outside of the premise. Our aggressive push to lower costs of bandwidth and provide greater coverage has begun to boost demand for our corporate product, which is a robust bidirectional, symmetric, either 1-gig or 10-gig interface. Corporate customers are increasing buying connections in carrier-neutral data centers for redundancy to support their user's ad hoc VPNs and a hybrid work environment.

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We remain focused on our salesforce productivity and continue to improve our sales training program and manage out underperformers. On a sequential basis, our sales rep headcount increased significantly by 45 (inaudible) reps or 9.4% sequentially and 1.2% year-over-year to a total of 522 reps.

Our number of full-time equivalent reps also increased to 465 from 449. Our salesforce turnover rate continued to improve and was reduced to 5.5% per month from the 5.9% we reported in Q2 and from the peak rate of turnover during the pandemic of 8.7% per month. This is a direct result of having our salesforce back in the office and having our ability to do in-person training.

Now, for a few summary remarks. We remain optimistic about our unique position in serving small and mid-sized businesses that are located in the central business districts of major cities and a 1,832 large multi-tenant office buildings on our network representing nearly a billion square feet of office space. We are excited about adding a new customer segment that is large enterprise customers and also adding optical transport networking, OTN services or commonly known as wavelength services, to our product portfolio as a result of our acquisition of the Sprint business.

Currently, key indicators for office activity, including workplace reentry and leasing, remain below pre-pandemic levels. However, we are encouraged that many tenants have indicated that a return to office in 2022 is going to continue, and leasing activities for commercial office space have begun to rebound.

We are optimistic that with the combination of our sales team being in office and the return of our customers to a more normalized work environment, we will benefit from selling tenants who have deferred or delayed network upgrade decisions due to the pandemic. Many companies are establishing long-term network architectures that will support a permanent hybrid work policy. As certain corporations elect to downsize their office requirements in multi-tenant buildings, the number of tenants per building will actually increase, increasing Cogent's on-net corporate opportunity. We also will benefit from selling our services to new tenants who are occupying these buildings as a direct result of the aggressive leasing that's being done by landlords across the U.S. and Canada.

Our targeted multiyear constant currency revenue growth rate remains 10%, and our long-term EBITDA margin expansion rates will be approximately 200 basis points per year. However, once we have combined with Sprint, our revenue scale increases by nearly 90%. Our growth rate will decelerate between 5% and 7%, and our EBITDA margins, once we have completed the network synergies, will be consistently able to grow by about 100 basis points a year.

At quarter end, cash held at Cogent Holdings was $84.6 million, and we had an additional $122.8 million at Cogent Group, which is freely transferable to Holdings, giving us $207.4 million of unrestricted cash available for either dividends or buybacks. Our Board of Directors once again improved a sequential increase in our dividend. This is the 41st consecutive sequential increase in our dividend, increasing our dividend at $0.01 per share to $0.915 per share. This represents a 4.4% annualized dividend growth rate which is in line with our current growth rate and free cash flow. Our consistent dividend increase demonstrates our continued optimism about our business' ability to generate increasing amounts of free cash flow. We are diligently working through the approval process to complete the acquisition of the Sprint Wireline business.

We are excited and optimistic about the improved cash flow generating opportunities that we will have with a larger and more globally diverse product and customer base. We anticipate the acquisition to close by mid to end of year 2023.

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

Operator

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Thank you. (Audio interference). Please go ahead.

Walter Piecyk

Thanks, Dave. Can you just take us through the conversation with the Board that led to the reduction in your sequential increase in the dividend—kind of what the thought process was there and how we should think about that going forward, especially post Sprint closing?

David Schaeffer

Right. So, Walt, as I reiterated on last earnings call and in numerous public venues over the last quarter, it is necessary for the growth rate and the dividend and the growth rate and free cash flow to come into alignment. I think the Board looked at our current rate of growth and cash flow. They were encouraged by the underlying improvements in our corporate business, but are also realistic that the improvements in the corporate environment are going to take some time. So, in order to mitigate the increase in net leverage, the Board decided to moderate the rate of dividend growth to that 1% or $0.01 per share or 4.4% annually. We will continue to monitor the improvements in our business and its free cash flow generation. We are committed to being efficient stewards of capital and returning that capital to shareholders through either dividends or buybacks, and it is our expectation that our growth rate and free cash flow will reaccelerate in conjunction with the improvement and our corporate business, but we are uncertain how quickly that improvement will occur. So, it seems more prudent to the Board to take this more moderate rate of increase in the dividend.

Walter Piecyk

Got it. Then just one follow-up is—seeing how this swap has performed for you guys over the past year or so. Just looking—given your outlook—you know, for your Company, the macro, the new mix of business, any change or any thought on what might change your target leverage ratios for the Company, or are you satisfied with the current targets?

David Schaeffer

Yes. So, you are absolutely correct; the swap has not worked out as well as we had hoped. While we had initial cash savings of $1.8 million, as Tad indicated, we will be in a cash deficit—this interest payment that will be made today of $3.4 million. So, a net economic loss on the swap of about $1.6 million, we did not anticipate the velocity and magnitude of interest rate increases. While we anticipated some, the increase in the Fed’s Fund rate has been more accelerated than we had forecast. We also think that the underlying rate of inflation will continue to moderate, and therefore that rate of increase and interest will moderate and may even decline and most likely will decline during the swap period. So, I think the jury’s out between now and 2026, we still think that the swap was the right decision, and we will be better off because of it because we will have diversified our borrowings to about 50% fixed and 50% variable.

Now, to the second part of your second question, which is the ultimate leverage target, our range is 2.5 times to 3.5 times on a net basis. We are at 3.93 today, which is about that range. We do have excess cash on the balance sheet, and as we have communicated to investors consistently—actually over the past decade, our goal has been to disgorge cash and return more than 100% of free cash flow to our equity holders. That policy remains in place. We think with the more moderate rate of increase in the dividend; we should expect to see the net leverage up—relatively peak where it is now and begin to decline. So, we are going to take a measured approach. We will look at the growth in our free cash flow and remain committed to returning that cash flow to equity.

Walter Piecyk

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Got it. Thank you. Thanks, Dave

David Schaeffer

Thanks, Walter.

Operator

The next question will come from James Breen with William Blair. Please go ahead.

James Breen

Thanks for taking the question. Dave, you talked about some of the long-term targets for the business once the acquisition closes from a growth perspective. Can you just talk about how it might change the absolute EBITDA levels and Capex levels? Then also assuming that Capex jumped quite a bit this quarter sequentially, can you just talk about some of the puts and takes there? Thanks.

David Schaeffer

Yes. I am going to take the Capex one first and then talk about long-term target secondly. Our Capex has been elevated for two—well, up to this quarter for one reason and now for two. The first reason which still exists is we are ordering excess equipment because of supply chain constraints from our vendors. The equipment that we order is modular. We order a complete tip (phon) of configuration and find ourselves receiving maybe only 70% or 80% of what we had ordered, and then miscellaneous and somewhat random components ship much later. That has forced us to carry much higher levels of equipment and inventory than we are accustomed to. We believe—and this is in discussions with Cisco, our main vendor, that we have passed the worst of these component shortages, and the ability to ship in a more normalized schedule will continue to improve over the next 6 to 12 months, and we'll be back to a more normalized, order-to-delivery cycle, and we will be able to draw it down on those inventories.

The second expenditure which was unique to this quarter was the beginning of spending monies to interconnect our network with the Sprint network in multiple locations around the world. We had told investors that there would be a one-time expenditure of about $50 million to achieve those interconnections. Some of the Capex that we spent is as a result of these one-time expenses, and they will continue for the next several quarters. We can actually do this work anticipatorily and in advance of getting the regulatory approvals. Now, we do run the risk of not getting regulatory approvals, but we view that risk as de minimis. Our purchase agreement does include a traditional hell and high water provision, so both sides will do what it takes to get this deal through the regulatory approval process.

On a going-forward basis, the combined company will have a revenue scale at close of about $1.1 billion, up from Cogent's roughly $650 million scale. As a result of that larger scale and our new product wavelengths, we anticipate that the going forward annual capital expenditures for the larger combined Company will be about $30 million higher than they would have been per Cogent stand-alone. So, two things, the one-time $50 million set of extraordinary expenses, and then two, the recurring $30 million of incremental going forward.

Now, for the long-term targets, both around revenue growth and EBITDA. Cogent's core business has been tremendously negatively impacted by the pandemic. We are seeing that negative impact subside, and our growth rate is returning. That's encouraging to us, and we think that trend will continue. We also are not comfortable in predicting exactly when we will return to that historic average organic growth rate for Cogent's business of 10% per year, but we feel comfortable we will. We also know that of the $450 million of revenue that we are acquiring from T-Mobile, the Sprint business, most of that is concentrated

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in large enterprise customers that generate about $442 of that—$450 million in revenue. Because these are very long-term agreements and these companies have already configured their networks, we do not anticipate material growth out of that revenue stream—probably in the order of one to two percent annually.

But, the real meteoric growth in the combined business will come from our ability to sell the optical transport products or wavelengths. Today that is only an $8 million business at Sprint. We anticipate that within five years of closing, we can grow that to a $400 billion business. So, when we add these three legs of growth together, on a kind of more normalized basis, getting past this initial ramp-up in the wavelength business, we should find the combined Company with EBITDA margins in the low to mid-30's and the ability to grow topline 5% to 7% and the ability to expand margins consistently at about 100 basis points a year.

The slower margin expansion is a result of those relatively static large enterprise customer revenue streams and the lower margin associated with them. While in absolute dollars, they produce cash flow, they are not growing at the same pace as the other products in the Company. But, when we look at the ability to de-lever the (inaudible) question and return cash to shareholders, the combined Company is in a much more sustainable and scalable position than Cogent independently would have been.

James Breen

Just a quick follow-up to that. So, if you look at the combined Company revenue, obviously, a lot larger, but you are not taking on incremental debt. So, does that mean off of that sort of low to mid-30s EBITDA margin combined, you'll have a higher free cash flow yield because the expense will be small relative to the revenue that you have now?

David Schaeffer

That is absolutely correct, Jim. We will absolutely be producing significantly more free cash flow per share. Things may actually even be better than what we are forecasting, and again, we've tried to be transparent with investors. We are getting $700 million in cash over 54 months from T-Mobile. In our forecast of revenue growth and margin, we are taking the most conservative approach and not counting any of that as revenue. It is highly likely that we can count some, possibly even all, I think that's unlikely, of that as revenue. If that is the case, our revenue growth will actually have a material step function up with those payments, and our margins will be much better than what we are predicting.

James Breen

Great. Thanks.

David Schaeffer

Thanks, Jim.

Operator

Our next question will come from Frank Louthan with Raymond James. Please go ahead.

Frank Louthan

Great. Thank you. When will you know what that status is, with what you are able to recognize, and then is the Sprint network kind of on the same pace that it was in some of the business it was declining and so forth? Is that still on the same pace that it was when you announced the deal? Thanks.

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David Schaeffer

Yes. First of all, let me take the rate of decline. It's actually accelerating Frank, and the reason is in our agreement with T-Mobile, the subscale and unprofitable products are being end of lifed (phon). There are customer contractual obligations, so we can't turn off the switch. We are working with the engineering teams at Sprint and also the sales teams to give customers alternatives. By design, we expect the revenue stream to decrease by close to 25% from $560 million, down to $450 in about the one-year period from announcement to closing. That's actually about twice as fast as the rate of decline had historically been. However, once that set of unprofitable products is purged from the network, we expect the remaining products to remain stable, and our ability to increase throughput by bringing those customers on-net using our metro footprint not only improves margin but it allows the customer to get a 10x increase in their ultimate services. Tad?

Thaddeus Weed

Yes, with respect to accounting for the contract, IP transit contract with T-Mobile, the accounting for that will be combined with the acquisitions since that contract is entered into at the same time as the acquisition. The final determination will be made once the appraisal is performed of the acquired business. We would expect that to be performed at the same time in the second half of next year. I will say, on a preliminary basis, it appears that the majority of the IP transit payments would be straight-line revenue over the term—over the 54 months.

David Schaeffer

Yes. We are going to ultimately need that appraisal and work with our auditors, Ernst & Young, before we're comfortable and reporting that exact number to our investors.

Frank Louthan

Right. Great, thank you very much.

Thaddeus Weed

Thanks, Frank.

Operator

Our next question will come from Nick Del Deo from MoffettNathanson Securities. Please go ahead. Nick, you line is unmuted. Please go ahead.

Nicholas Del Deo

Oh, sorry. Morning guys. Sorry about that.

David Schaeffer

That's okay, Nick.

Nicholas Del Deo

You figure, two and half years in, you'd remember to unmute, but—first, one quick clarification, and then, two more subsequent ones. I didn't write the numbers down fast enough as you were speaking. Were the

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total expected savings you articulated for the Sprint deal in your prepared remarks the same as what you shared at recent investor conferences?

David Schaeffer

The answer is yes, they were identical. Absent SG&A and headcount numbers, we're anticipating and aggregate set of savings of about $220 million a year. That being $180 million of North American Sprint network savings, about $25 million of international Sprint network savings, and approximately $15 million of North American Cogent network savings.

Nicholas Del Deo

Okay, great. Thank you. So, first real question, your principal payments on capital leases were at record level, and your capital lease obligations were up about $34 million sequentially, which is pretty meaningful. What's behind that? Was there any sort of ROU or reclass like you had a couple of years ago, or was it something else?

David Schaeffer

So, two very different things. The first point is we began to acquire IRU's for fiber to physically interconnect the two networks. When we do that, there's both a cash payment upfront, which was relatively modest, but we also have to reflect in the lease balance all of the O&M over that term—and actually, for some of those new fiber routes, the term is actually 44 years. So, that number could be pretty large. The second thing that happened in the quarter is a major IRU in France ended. There was no upfront payment, but we elected to extend that for another 20 years, and that had to reflect that obligation for O&M over that 20-year period. So, those were the two reasons why both the balance and the initial payments increased.

Nicholas Del Deo

Okay. Were there any Opex impact to the extension in France?

David Schaeffer

No, because it already was a capital lease. When re-classification occurred three years-four years ago. The remaining several years of that move from Opex to Capex but, but just till that period. Then we had this one-time window that we could have walked away and elected to extend, and part of our extension was a negotiation with a counterparty for a lower CPI adjustment, which sounds counter-intuitive in this market, why they would lower the CPI rate of increase, but it's better to get something than nothing is kind of what we convinced them of.

Thaddeus Weed

What happened really with the transaction in France is we had a number of individual leases that were all aggregated and made coterminous under one long-term lease. So, both extended the term and simplified the ability of accounting for it and the contract.

Nicholas Del Deo

Okay. Okay. Makes sense. Last question, Dave, can you give us any updates on customer feedback or early expressions of interest you're getting, you know, regarding the potential to sell dark fiber or wavelengths post-Sprint close?

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Dave Schaeffer

Yes. So, NANOG, the North American Network Operators Group, which is an engineering forum, held its quarterly conference in Los Angeles about a month ago. I was not initially attending to—of planning to attend that conference, but chose to do so after we announced the Sprint deal just so I could sit down with the engineering teams of many of our key customers, as being folks like Amazon, Microsoft, Facebook, Charter, Cox, some of our larger NetCentric customers, and really kind of understand their wish list of what they would like to be able to purchase. I left those meetings not able to sign any orders because I can't until the deal closes, but very, very encouraged that there was a significant pool of demand for the services, and it was surprising to me that many customers had actually done their homework, came to meetings with shopping lists of very specific routes and city payers that they were interested in, and we told them we can provide these services they want at closing, but we could not take those orders yet.

Nicholas Del Deo

Okay. That's great to hear. Thank you, Dave.

Operator

Our next question will come from David Barden with Bank of America. Go ahead.

David Barden

Hey, thanks so much for taking the questions. Dave, just on that point—so, I guess as we followed the Company, we've got the NetCentric business where you've kind of had this very marginal costs, strategy on pricing, which I think was really geared towards scaling up your relevance to the industry, and then we've got the corporate side where you've been making the money, really focused on a very simple low-cost broad-based strategy.

As we think about this path between the $8 million and $400 million that you are trying to get to in the wavelength services, which of these two strategies is it? Is it mercilessly lower price to win incremental share and figure out the profit later, or is there something more like the corporate strategy where there is real money to be made in the nearer term?

The second piece, I guess, is related to the $700 million that you are going to get, I know that there is a tax potential piece—a taxable piece of this, I guess goes along with the audit that will happen alongside closing. Would be your intention to take that cash flow and apply it to your dividend thought process with the Board on the far side of the closing? Thank you.

David Schaeffer

Yes. So, I am going to take your first question first, and then, I am going to actually disagree slightly with the premise of the question, which is that we don't make money on the NetCentric business. The most profitable business at Cogent is our on-net services. In our corporate product mix, 60% of revenues come from on-net, and 40% come from off-net. In our NetCentric business, 90% of revenues comes on-net and 10% off-net. In the wavelength products, it will be virtually a 100% on-net offering. So, really the only practical way to sell it and as part of the reason why Sprint has struggled in the market.

We also have a network with, initially, day one, a negative cost basis. There is about a $2 billion addressable market that's dominated by two major players, Lumen & Zayo. We will be as aggressive in that market as we have been in the transit market. We rose out of a pool of 200 transit providers 20 years ago to now carrying nearly 24% of the worlds traffic, being number two, and literally within a couple of

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percentage points of being number one. We have the same kind of ambitions for our wavelength business. So, we will be aggressive. We don't want to destroy the market. We will capture share through the breadth of locations that we can offer and our pricing model. We will be profitable in doing this.

Now, to the—your kind of tax consequence of the payments from T-Mobile. The more of it that is recognized as revenue—and you heard Tad say the majority we think will be. We will still pay taxes, but we pay them ratably as opposed to upfront. If a portion of that is subscribed to the assumption of uneconomic contracts, we have to recognize that gain upfront and pay upfront. So, we're going to work with our tax advisors, with our auditor to come to the best answer we can for Cogent, but be compliant with all.

We look at the total fungibility of cash, and we are committed to returning an ever-increasing amount of cash to shareholders. Whether that's through dividends, buybacks, or combination, is measured by the Board each and every quarter. You saw that dynamic process play out this quarter, where we decelerated the rate of growth. That's not a lack of commitment and growth in dividend. It's just a reflection of what two years of COVID had done to our corporate business. We think that business is going to improve. The underlying or acquired Sprint business is going to improve, and we will have $700 million in advance of our need to reduce the cost. So, when we put all of that together, we believe that on a combined Company basis, we will be in a position every quarter, post-closing, to return more cash to shareholders than we would have as a stand-alone Cogent.

Now, whether that is dividends or buybacks, that's something that the Board will determine each and every quarter.

David Barden

Got it. Thanks, Dave.

David Schaeffer

Thanks, Dave.

Operator

Our next question will come from Brett Feldman from Goldman Sachs. Please go ahead.

Brett Feldman

Yes. Thank you, and two follow-up questions, if you don't mind. So, you're just talking about how you are going to be aggressive in the wavelength market when the deal closes. I think the point here you're acquiring assets have a low—I think you said negative cost basis, meaning it's the assets you are acquiring that you intend to leverage in the market. I don't think it's your intent to start deploying new capital because you could be doing that now. So, I want to clarify that because the question I really have is, what portion of the wavelength market do you think you can actually address with the assets you are acquiring? Then the second question—I am sorry if I got the stat wrong, but I think you said you are going to see this asset transition from 30 products today to four at close. So, it's a two-part question; one is the accountability of winding down all those businesses, and are there mechanisms to make sure that when you get the asset, not only the revenue but the expenses are gone so it's actually a clean asset? Then the fourth—revenue streams that you're going to be taking on, are they actually growing today, or did something have to happen to turn those into growth businesses at the close? Thank you.

David Schaeffer

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Yes. So, let's start with the wavelength business and dark fiber, which we haven't mentioned because we haven't totally sized that market. Dark fiber would be a 100% margin, and there's no incremental capital needed. It's just selling inventory. On wavelengths, it's a slightly more subtle answer in that when we're spending the money upfront to tie the networks together, so we have a maximum number of endpoints that we could sell, that's a one-time expense, but we need to do that for the IP and for the VPN business, anyhow so, it's not an incremental expense.

We also know that on a going-forward basis, the optical transport technology will continue to improve. The pluggable optics, the CR optics, and the transponder cards will continue to improve. While we will be inheriting a large inventory of that equipment, we will be spending capital to continue to modernize that wavelength portfolio to remain at the cutting edge of technology. That is embedded in our expectation of $30 million of incremental capital for the combined business. So, we think that we can eventually get to 25% to 30% of this market, maybe better, but we prefer to set our sights realistically and then raise our targets. We'll have to see how our competitors react.

So far, what appears to be happening is our competitors are going in different directions and focusing on different customer segments. Much as they have ceded share in transit to us, I think they will cede share in this product segment that will be very profitable for Cogent and maybe less profitable for them.

Now, to the product part of your question, Brett. The answer is most of these products will end-of-life prior to closing. There are customer relationships that extend beyond our expected close date, and some of these products, while end-of-life will still be supported. So, part of the $700 million payment from T-Mobile is to help us cover those negative costs. While we honor those contracts, we will not dishonor any contract to any customer that we are acquiring. What we will do, however, is go to those customers and most likely try to find an alternate provider. So, we will provide the connectivity, and they will provide the underlying service on top of that connectivity.

Now, to the revenue growth rates within the business. Basically, there are two major products that are being required, Internet access and VPNs based on MPLS. Both of those products are about $220 million of revenues. So, $440 million of the $450 million come from those two products. They have been relatively stable inside of Sprint for a number of years, but both of those would decline without us improving the service. So, what we will be doing is bringing the customers on-net, increasing the bandwidth per port by 10 times, and converting the back end of that VPN technology from a MPLS to VPLS service.

I actually reviewed a customer contract that was looking for an extension yesterday, and the customer pointed out that they have an over 40-year almost exclusive relationship with Sprint, and Sprint had previously migrated them from X.25 to Frame Relay and then Frame Relay to MPLS. They wanted a timeline for this—what they hope to be their last migration from MPLS to VPLS. So, that will happen. We believe that that large embedded base of revenue is basically flat. Maybe we can grow 1% to 2% a year, but we do not anticipate material growth or material revenue attrition. The attrition is coming through these end-of-life products, and the growth is coming through the optical transport products.

Brett Feldman

Great. A quick point of clarification, the 25% to 30% of the wavelength market, do you think you can address? Is that the U.S. wavelength market, or is there an international component to that?

David Schaeffer

It's North American, so it's U.S. and Canada, which is basically where we can utilize the Sprint network. We currently have no plans to expand that in Europe, LATAM, Africa, or Asia Pac. Obviously, if there were other acquisitions, we would look at that, but at this point, this is a North American product.

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Brett Feldman

Okay. Thanks.

Operator

Our next question will come from Sami Badri with Crédit Suisse.

George Engroff

Dave, this is George Engroff on for Sami. Yes, just touching on something that you mentioned last quarter, where you noted that the corporate growth rate was not materially impacted in prior recessions outside of the 2008, 2009 period. Has anything changed your view on a potential recession's impact to today's corporate growth rate? Or, should we think about the dividend deceleration and free cash flow alignment as just a normalization from the COVID period?

David Schaeffer

So, I'll take those in reverse order. I think the dividend growth rate moderation is just a recognition that the impact of COVID on our corporate business was longer and deeper than any of us anticipated. The recovery, while occurring, is slower than expected. It just seemed prudent to be able to align the growth in free cash flow to the growth and the dividend.

To the recession part of the question, the buildings that we serve tend to be the most desirable in every market. The tenants tend to be more recession-proof than the general business population. The only time we saw a negative impact from a recession was a two-quarter period at the end of '08 beginning of '09 in our corporate business in the great recession. Other recessions have not negatively impacted our corporate business.

The fact that there is so much talk of recession, and we're seeing continued improvement, albeit slow, in our corporate business, we don't think there is a material risk to either our revenue streams or our ability to continue to grow the dividend. We also have been extremely fortunate that our NetCentric business is somewhat countercyclical. That's actually been a historic pattern, not just COVID, that when there's a recession, people stream more video, and therefore, they actually end up consuming more bits and generating more revenue for us. I think these trends are in place and independent of what happens in the macro environment—absent some kind of major depression, we feel comfortable in our ability to grow the dividend.

George Engroff

Got it. That's helpful. Then just as a follow-up, I know in the past, the Board of Directors have been sort of hesitant to change the dividend growth rate. So, I guess following—adding on to that, if the growth rate in free cash flow does reaccelerate at a certain point in time, is there going to be a sort of similar lag where you—the Board of Directors wants to see and make sure that it is going to be a sustained reacceleration? I guess, what sort of way should we be thinking about that?

David Schaeffer

Yes. So, first of all, the Board has improved the growth rate in the dividend multiple times. It initially was $0.01 a share, $0.01 to $0.02, and then $0.025 a share. So, the Board has looked at the underlying performance and responded. This response was basically the recognition that the corporate improvement is slower and less linear than we expected even six months ago. I think the Board would react pretty

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quickly to reaccelerating the rate of dividend growth if cash flows continue to improve. Also, if interest rates moderate, the ability to use the balance sheet and take on leverage makes more sense. So, we would look at both of those factors.

George Engroff

Great. Yes, thanks. Congrats on the quarter.

David Schaeffer

Hey, thank you very much.

Operator

Our next question will come from Michael Rollins from Citi. Please go ahead.

Michael Rollins

Hi, thanks for taking the question. Two, if I could. First, if you look at the market share that you have currently in corporate buildings today of about 14%, Dave, what's the range of outcomes you're seeing in buildings, or you've been operating in them for more than a year or two? What do you think is the path for just pushing that higher? Is it just simply the return to office? Or, are there some other steps that the Company is taking to push the share up?

Then just, separately also in these corporate buildings, are you seeing any significant interest or demand for private wireless networks? Is Cogent a natural partner to either provide the fiber connectivity for those networks or to actually provide and enable those private networks with DAS and small cells and just make that open to whichever carrier wants to join into that? Thanks.

David Schaeffer

Yes. So first of all, the best buildings that we are in, we have some buildings that we have 90-plus percent market share. That is not normal. Those are buildings where the tenants tend to be the most levered to bandwidth and, therefore, are more interested in Cogent's products. I think what hurt Cogent's corporate business is three factors. One, very obvious, increase in vacancy rate. That's easy to understand. There's just less people to sell to in the building. Two, many customers basically stopped making changes because of the uncertainty of COVID and the uncertainty around work from home versus return to office. I think that picture is still not perfectly clear to every company, but it's increasingly coming into focus, and things are improving. That improvement and clarity is allowing customers to now place orders, and it's helped us improve our corporate growth rate. The third factor is we had a salesforce that was remote. While we tried as hard as we could to make them as productive as they could be when they work from home, because of our high turnover in a direct sales position that's telemarketed, we saw a decline in rep productivity. Now that we've brought reps back to the office, our trainers are there in person, we have seen rep productivity improve and rep turnover decline.

Again, we can't predict the pandemic, but we sincerely hope that with the vaccine policy that we've implemented, that will not ever be forced to send our people home again. I think this was a once-in-a-lifetime event, maybe, hopefully, once in hundreds of years, and as a result of that, all three of these factors, I think, will help us improve our productivity.

Now, to your second question about WiFi networks, DAS networks, and small cell. We have worked very limitedly with some wireless carriers to provide all three of those different solutions. The vast majority of our buildings, we have the right to do that.

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There are a small percentage of our buildings where we would have to go back to the landlord to get an additional right, but that would not significantly impact our ability to participate in this segment. So far, all three of these technologies, I would say, are limited and how widely they're being deployed. So, the answer is yes, it's an opportunity, yes, we're talking to the right players, but today, it's not a meaningful contributor to our revenues.

Michael Rollins

Thank you.

David Schaeffer

Thanks, Mike.

Operator

Our final question comes from Bora Lee with RBC Capital Markets. Please go ahead.

Bora Lee

Thanks. Just one question from my side. Hi, Dave. Historically, you've spoken about Capex declining over time. Given the international markets expansion—and you've indicated that you're interested in actually expanding internationally further, given the opportunity provided by the Sprint assets, how should we be thinking about Capex? Would it be elevated for like three to five years or x-number of years before it starts returning—resuming at a downward trajectory? Or are those—is that international market expansion actually included in that $30 million Sprint Capex figure you cited earlier?

David Schaeffer

Yes. So, the answer is it does include our international expansion. We, again, have tried to be very transparent. There's going to be this $50 million that we need to spend initially to harmonize the networks and/or connect them. That's a one-timer. We also, quite honestly, did not anticipate the equipment supply chain issues that we've had to face for the past year and half. For the first six months of the pandemic, that was not an issue. It probably peaked a couple of quarters ago, and it is improving, but there are still chip shortages of key components. As a result, we've had to spend more capital and over-inventory gear. That should go away. As a percentage of revenue, our Capex should decline, and even on an absolute basis, it should decline. But, because we are picking up the wavelength product, the revenue scale is larger; rather than get to a non-expansion Capex number of $35 million, which was our maintenance number for Cogent, I think that number will be closer to $65 million for the combined Company. We do think there will still be some additional expansion Capex spent every year for the foreseeable future. I outlined the 100-plus data centers a year that we will be adding. So, I think for the next several years, investors should expect much more than $65 million. Remember, each data center is about a $120,000 expense roughly, and we're going to add a 100 of those. We are going to still add a handful of MTOBs. So, our Capex will go down, but it won't get to that maintenance level for several more years.

Bora Lee

Great. Thanks so much, Dave.

David Schaeffer

Hey, thanks, Bora.

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Operator

That will conclude today's question-and-answer session. I'd like to turn the call back to Mr. David Schaeffer for closing remarks.

David Schaeffer

I'd like to thank everyone. I know our calls go long, but we try to answer all of the questions. I appreciate everyone's support, and we will talk soon. Take care. Bye-bye.

Operator

This will conclude today's conference. Thank you for your participation and you may now disconnect.

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