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Conference Call Transcript

VG - Q2 2010 Vonage Holdings Corp. Earnings Conference Call

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PRESENTATION

Operator

Good day, everyone, and welcome to the Vonage Holdings Corp. second-quarter 2010 earnings conference call. Just as a reminder, today's call is being recorded. At this time for opening remarks and introductions, I would like to turn the conference over to Ms. Leslie Arena, Vice President of Investor Relations. Please go ahead.

Leslie Arena - ***Vonage Holdings Corp. - VP, IR***

Thank you. Good morning and welcome to our second-quarter 2010 conference call. Speaking on our call this morning will be Marc Lefar, Chief Executive Officer; and Barry Rowan, CFO and Chief Administrative Officer.

Marc will discuss the Company's progress in the quarter and our newly announced Vonage Mobile app for Facebook. Barry will discuss our financial results. Slides that accompany Barry's discussion are available on the investor relations website.

At the conclusion of our prepared remarks, we will be happy to take your questions. As referenced on slide two, I would like to remind everyone that statements made during this call that are not historical facts or information may be forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995.

These and all forward-looking statements are based on management's current beliefs and expectations and depend on assumptions or data that may be incorrect or imprecise. Such forward-looking statements are subject to risks and uncertainties that could cause actual results to differ materially. More information about those risks and uncertainties is highlighted on the second page of the slides and contained in Vonage's SEC filings.

We caution listeners not to rely unduly on forward-looking statements and we disclaim any intent or obligation to update them. During this call, we will be referring to non-GAAP financial measures. A reconciliation of these measures to comparable GAAP measures is available on the investor relations website. And now, I will turn the call over to Marc.

Marc Lefar - ***Vonage Holdings Corp. - CEO***

Thank you, Leslie, and thank you all for joining our call today. It is our pleasure to update you on our continuing transformation progress and our operating results for the quarter.

We reported a very strong quarter on many fronts with record high EBITDA and cash flow generated from operations and solid progress on our balance sheet. At the same time, we took concrete steps that lay the foundation for our future growth; we added key individuals to our executive team and board of directors, launched our exciting new mobile application for Facebook users and continued to improve the customer experience reducing churn to its lowest level in three and a half years.

We generated $41 million of EBITDA, a 30% increase from the prior year and our eleventh consecutive quarter of increasing EBITDA, and generated record high free cash flow of $81 million during the quarter. We continued to improve the balance sheet as we retired $18 million of debt at par. This is in addition to the $23 million retired last quarter. Taken together, these actions reduce interest expense by $33 million over the life of the loan. This is significant progress.

Operationally we reduced churn to 2.3% and stabilized our customer base with a modest loss of 5000 net lines.

And we continue to build our team with experienced technology leaders that will expand the capabilities of our network and deliver breakthrough services.

In May, we announced the appointment of Amichay Oren as head of Research and Development; Amichay previously held senior roles at Ja Ja and SAP, following SAP's acquisition of Expression, a company that Mr. Oren co-founded. And, yesterday we announced the addition of Dr. David Nagel to our Board of Directors. Dr. Nagel is widely known for his deep technical background and has held senior leadership positions in consumer technology companies including Apple, AT&T and Palm. He was most recently President and CEO of Palm Source and prior to that, he was Chief Technology Officer at AT&T and President of AT&T Labs. We're very pleased to have him join the Board.

The decision by these talented individuals to join Vonage is a testament to the attractiveness of our strategy and our commitment to executing on it. Amichay and his team, along with many other Vonage employees are already contributing to the implementation of our vision, they were instrumental in enabling the launch of our new mobile application for Facebook.

If you didn't see the press release, earlier this morning we announced an innovative new service that allows users with our application to make and receive free mobile calls between Facebook friends, anywhere in the world. directly from their friends' list. with a single touch.

It works on WiFi, 3G and 4G networks and is available for the iPhone, iPod Touch and Android devices. An iPad app is coming soon.

This new service works with the user's existing network of Facebook friends. So there's no need to remember screen names, to input numbers or create a new user name in a new community. The user simply logs in with their Facebook credentials one time and their friends become their contact list for free calling.

In the past, I've talked about how a single "familiar" identity such as a user name or number allows a person to initiate and receive calls and messages from their existing social network or contact lists while on any device. This application brings that concept to life and is a good example of our long-term commitment to deliver great value and a better communications experience.

This concept is not limited to a single community. This is just the starting point for a wide range of future capabilities that can change how people communicate. People don't have to be identified by a number any longer. Over time, "dialing" as we know it today can be virtually eliminated. Voice, messaging and video can all be initiated with a single touch using communities to which consumers already belong. And a single user will be able to use multiple devices seamlessly. PC and Mac integration are in the works.

Our IP-based communications platform enables cost-effective delivery of these services, allowing us to provide customers with more value than exists today. For example, online and mobile chat services require customers to get online in order to receive messages. And SMS, while providing customers with real-time messaging, limits messages to 160 characters. Our approach does not require presence and could allow larger message lengths with attached media such as pictures or video at a lower cost to the consumer. This is just one example.

Multiple communities, even families, can be integrated into Vonage Mobile and we anticipate a full range of services, many of which may be monetized, including lower cost text messaging, premium services like readable voicemail and custom communities.

Of course, we will also continue to provide the ability to complete calls off -net. This will be especially valuable for international communications with countries and segments where smartphone penetration and broadband availability lag.

We do believe that many of our next-generation services will have global appeal and our new application will be available for download from the iTunes app store in 87 countries and from the Android Market in 48 countries within the next day or so. It's available in the U.S. and Canada now.

Based on this glimpse of the future, I hope you'll share my excitement about the emerging opportunities for Vonage. As we've said previously, we expect these next-generation products will begin to contribute measurably to revenue in 2011.

Let's now move to a review of the quarter's results.

I already highlighted our strong results in EBITDA, free cash flow and the substantial progress we've made on our balance sheet. Barry will discuss these in greater detail.

Our core business is strong and continues to generate significant cash flow. We again delivered strong improvements to our cost structure through operating efficiency and cost management across the company. We reduced SG&A by double-digit percentages year over year. Customer care costs per line were down more than 20%, driven by operational improvements, and we improved customer satisfaction leading to fewer customer contacts. We continue to aggressively negotiate rates with carrier partners to reduce international long-distance costs per minute which declined 7% sequentially.

Churn continues to be a very strong story, declining to 2.3% this quarter. This represents a 90 basis point reduction from a year ago. These results continue to be driven by our customer mix with international long-distance callers churning at less than half the rates of domestic callers and a relentless focus on every element of the customer experience. The impact of this detailed operational focus can be seen in the 16% reduction in the number of calls into customer service. And, in our post-30 day save rate or stick rate which increased 10 percentage points from the beginning of the year, highlighting the great work done by our retention teams.

We also continue to strengthen the quality and reliability of our network. The percent of impaired calls continues to trend down year over year and we have reduced the frequency of call interference every quarter since the third quarter of last year aided by call quality tools and metrics which provide real-time information on network problems.

Importantly, we stabilized our customer base, reducing line losses as we indicated we would on last quarter's call. Net lines lost were 5000, a sequential improvement of 21,000. We increased gross line additions by 11,000 from the prior year on $3 million less in marketing spend. Gross line additions of 155,000 were flat sequentially.

We continue to test new products and rate plans that address the evolving needs of our customers. In June, we tested a $9.99 offer targeted at low usage customers. While we saw some lift in customer additions and improved customer quality profiles during the month, it's too early to assess the full impact of the offer. Early results showed that high credit quality customers are attracted to this offer and the percent of all Vonage customers signing up through our online channel has increased to nearly 60%. Both of these factors have historically correlated to lower churn. We will continue to assess the performance of these promotions and the cost/benefit trade-offs.

We are also taking additional steps towards our strategic priority of serving international long-distance consumers. Our highly competitive Vonage World product which bundles unlimited domestic calling with unlimited calling to 60 countries provides a compelling value proposition to customers and attractive economics to us. And just this week, we launched our Spanish-language website. This along with our Spanish-language call center provides an end-to-end Spanish-language experience that makes the Vonage World plan more acceptable to Spanish-speaking customers and offers a simple and affordable way to call friends and family back home.

We continue to extend the reach of Vonage World across ethnic segments and internationally by leveraging Vonage World's success in the Asian Indian community and we have our plans to launch Vonage World-Canada in the coming months. Additionally we are evaluating new ideas beyond traditional advertising including trade organization partnerships and sponsorships to accelerate sales into our targeted ethnic communities.

A search is currently underway for a Chief Marketing Officer to replace our former CMO who left the Company at the end of the second quarter. I will remain personally engaged in the marketing role until that position is filled.

In summary, it was a very strong financial quarter. We delivered record level EBITDA and cash flow and paid down a meaningful amount of our debt. We launched our Vonage Mobile application for Facebook users, taking a major step towards enabling communications across social communities and we continue to make progress improving the value generated from our core business. We are enthusiastic about our future as we look forward to delivering compelling and innovative products to meet the emerging communications needs of our customers.

And now I'll turn the call over to Barry.

Barry Rowan - ***Vonage Holdings Corp. - CFO and CAO***

Thank you, Marc. I am very pleased to review our financial and operating results for the quarter in more detail with you. As Marc highlighted, it was a very strong financial quarter as we generated record high EBITDA, record-high cash flow, the lowest churn in three and a half years and continued to improve our balance sheet. In the past four months alone, we have reduced our term debt obligations by $41 million resulting in interest expense savings of at least $33 million over the life of the loan. These reductions in principle supported by strong free cash flow have enabled us to reduce our net debt balance from $197 million a year ago to $72 million using a net debt leverage ratio of 0.5 times. Let's walk through the details of our results beginning on slide 3.

Our attractive business model with its high service margins and increasingly satisfied customer base is delivering on its financial promise, as we generated EBITDA of $41 million on $225 million of revenue. That's a 30% increase in EBITDA from a year ago and a respectable 18% margin. These gains have been driven by higher ARPU and cost management and operating efficiencies primarily in customer care, legal facilities and payment processing.

You will see on slide 4 that we generated $12 million of Net Income excluding non-cash charges, up significantly from the $1 million level a year ago and on par with the $12 million generated last quarter. GAAP Net Income was a negative $600,000, rounding to zero cents per share in Q2, and the $15 million reduction in net income from last quarter is predominantly due to non-cash charges related to two positive circumstances.

First, Net Income for the second quarter includes a $4 million charge relating to the $23 million in debt we prepaid at par this quarter. Secondly, it includes an $8 million non-cash expense related to unconverted third lien notes reflecting the $0.95 increase in our stock price in the second quarter.

Turning to slide 5 -- Total revenue for the quarter increased to $225 million from $220 million in the second quarter of 2009. Telephony services revenue was $222 million, up 3% year over year and down 1% sequentially.

The year-over-year improvement was driven by higher average service revenue per user which increased 9% or $2.53 from the second quarter of 2009, reflecting an increase in the number of customers signing up for higher priced rate plans, higher fees and improved customer quality which lowered bad debt costs.

We indicated on last quarter's call that we expected ARPU to decline slightly sequentially which it did as service ARPU fell $0.19 or less than 1% from the first quarter. This was a result of promotions which were partially offset by other rate favorability including the fee increase for unlimited 411 directory assistance introduced during the second quarter. As we look to the third quarter, we do expect ARPU to decline modestly as a result of pressure from promotions.

Moving to slide 6, our direct Cost Of Telephony services or COTS was $63 million, roughly flat sequentially and up from $51 million in the prior year as anticipated due to International Long-Distance usage by Vonage World customers. We continue to focus on driving down termination rates both internationally and domestically and have reduced our overall ILD cost per minute by more than 50% since the second quarter of last year and 7% sequentially. This represents approximately $20 million in cost savings on second quarter COTS had our rates stayed at the year-ago levels.

We pointed out last quarter that ILD users of Vonage World carry a higher Net Present Value than domestic-only callers as the higher COTS is more than offset by the benefit of customers churning at less than half the rate of their domestic counterparts. As we continue to reduce our cost of delivering calls for these higher usage customers they become even more valuable to us throughout their customer life.

Looking ahead, we are planning for an increase in total COTS during the 2nd half of 2010 as the usage from our growing base of Vonage World customers is expected to more than offset the savings on termination rates. Direct margins of 66% were down from 69% in the second quarter of last year, reflecting the higher COTS associated with the growth in these high value international calling customers. On a sequential basis, direct margin increased by 1%.

Moving to slide 7, our continued focus on driving operating efficiencies and productivity improvements drove SG&A reductions of 15%, to $61 million from $71 million in the year ago quarter, resulting in SG&A as a percent of revenue of 27%, down from 32% a year ago.

Excluding one-time severance and litigation costs incurred last year, SG&A was $5 million lower than a year ago. We have lowered per line customer care costs by 21% during the past four quarters through a relentless focus on the operational elements of well-executed customer care, improving agent staffing levels; reducing the number of customer contacts through improved customer facing processes, as we transferred 29% fewer calls vs. the prior year and increased on-line self-service. We will continue to pursue structural cost saving opportunities through our tactical initiatives process which includes for example a focus on increasing the percentage of our sales and support functions performed on-line.

You can see from slide 8 that we generated $100 million or $13.89 per line in Pre-Marketing Operating Income (PMOI). We believe this metric particularly highlights the cash generation capability of our core business model.

Turning to slide 9 - we held marketing spend flat with Q1 at $49 million for the quarter, adding 11,000 more Gross Lines than a year ago on 5% less marketing spend resulting in 12% lower SLAC. Sequentially we achieved the same 155,000 in GLAs on the same marketing spend resulting in identical slack of $318.

While these GLA levels are lower than we hoped for coming into the year, we are pleased with the progress in stabilizing our customer base. As we look to the third quarter, we expect marketing spend to be roughly flat sequentially.

Slide 10 depicts the substantial progress in churn which Marc highlighted. The 2.3% churn results this quarter were the best since the fourth quarter of 2006 -- the lowest level in three and a half years -- and reflects an improvement every quarter since Q3 of last year.

As we've stated, these substantial improvements in churn are driven by two factors. A growing mix of ILD callers churning at substantially lower rates and continuing progress in enhancing the end-to-end customer experience.

The strong churn results led to a narrowing of net line losses from 26,000 last quarter to the 5,000 in Q2, meeting the expectations for an improvement in Net Adds from Q1 to Q2 we'd set on the last earnings call. We are pleased with the positive results in stabilizing our customer base as the relatively modest 5,000 line decline in this quarter compares to the more than 40,000 lines lost on average per quarter for the past year.

We believe this progress in solidifying our base of both customers and cash flow provides a solid foundation on which we can build the compelling long-term vision for Vonage that Marc described.

Now let's move to a discussion of our balance sheet and cash flow results -- headlined by strong cash flow, continuing progress in paying down debt at par, a substantially improving Net Debt position and freeing up cash previously held by vendors. These results are summarized on Slide 11.

Our operational results were indeed strong. We generated $93 million in cash from operations and increased total cash to $179 million at quarter end which includes $54 million in restricted cash.

Capital expenditures were $12 million in the quarter and have totalled $16 million year to date. We are still expecting full-year capital expenditures to be in the mid-$40 million range.

Free cash flow was $81 million for the quarter although we would point out that this includes a substantial increase in cash due to changes in working capital which we would not expect to occur on an ongoing basis. We are again pleased to report that we used the strong cash flow from this quarter to reduce our debt balance.

As a reminder, the debt agreements provide that once our unrestricted cash balance exceeds $75 million which occurred during the first quarter, half of the calculated "Excess Cash Flow amount" is offered to debtholders to retire the debt at par. That process continues each quarter thereafter with 50% of ECF offered to pay down 1st lien holders at par, and any remaining funds then offered to 2nd lien holders through a similar process.

Through this Excess Cash Flow sweep mechanism, we made an offer to our debt holders to redeem $41 million of debt at par. While certain holders waived their right to receive the prepayment, others accepted the offer, reducing our principal balance by $18 million - $5 and $13 million respectively for the first and second liens.

While the full amount of the offer was not taken, we are pleased to have redeemed this additional debt at par through the ECF mechanism and we believe that the holders' interest in maintaining their position is an indication of their confidence in the company's performance. After giving effect to the debt paydown, the principal balance remaining on the first lien is $99 million and the second lien is $87 million.

The combination of this debt paydown over the last two quarters and our strong cash generation has resulted in a substantial reduction in Net Debt in recent quarters. Slide 12 reflects that our Net Debt (defined as gross debt less; unrestricted cash and the $30 million concentration account) stood at $197 million a year ago and has been reduced to $72 million as of the end of this quarter, yielding a 0.5X Net Debt leverage ratio, calculated as net debt divided by trailing four quarter EBITDA.

Combined with actions taken in Q1, we have reduced our debt by $41 million, resulting in interest expense savings of $4 million in 2010 and $33 million over the life of the loan. We do not anticipate generating the same level of excess cash flow again next quarter primarily due to the contribution from working capital changes this quarter but we do remain focused on continuing to improve our capital structure.

As we have said in the past, we are comfortable that we can continue to satisfy debt obligations. That said, this early debt retirement is great news and is part of our continuing focus on opportunities to reduce our debt.

We continually assess our capital structure and from time to time discuss with lenders opportunities to repay, refinance or revise the terms of our credit agreements though of course there can be no assurance that such efforts will be successful on terms acceptable to us or them. One final note on the balance sheet is the progress we made in freeing up restricted cash during the quarter.

We highlighted on the last earnings call what we believed to be an opportunity to reduce the non-debt portion of restricted cash and successfully released $29 million in deposits during the quarter. Through discussions with our vendors and as a result of improvements in our credit quality, $17 million in previously restricted cash was released in the second quarter and $3 million was released just after the end of the quarter.

In addition, our device manufacturer returned $9 million that was classified in other long-term assets which also contributed to the Excess Cash Flow generated during the quarter. We are very pleased to have been able to release this cash as a result of our sustained positive financial performance.

In summary, it was a very strong financial quarter operationally and for the second consecutive quarter, we made substantial progress on the balance sheet leading to significant interest expense savings. With the stabilization of our customer base, we expect third-quarter revenue to be roughly flat year over year and down slightly sequentially largely due to the impact on ARPU from promotions as we described.

Our expectations for third-quarter EBITDA are for year-over-year growth but with a modest decline sequentially due to growth in the base of Vonage World subscribers, the continuing impact of promotions and increased investment in new products. We continue to expect next-generation Vonage services to meaningfully impact revenue beginning in 2011.

And now I'd like to turn the call back over to Leslie and we'd be happy to address your questions.

Leslie Arena - ***Vonage Holdings Corp. - VP, IR***

Thank you, Barry, and now, operator, please open the line for questions.

QUESTION AND ANSWER

Operator

(Operator Instructions) Michael Rollins, Citi Investment.

Kevin Toomey - ***Citi Investments - Analyst***

This is Kevin Toomey calling for Mike Rollins. Just one question, how long can we expect [CFFO] to stay above OIBDA less interest expense? Is there a reversal coming and what should we expect for the second half of the year? Thanks.

Leslie Arena - ***Vonage Holdings Corp. - VP, IR***

Kevin, can you please repeat the question?

Kevin Toomey - ***Citi Investments - Analyst***

How long can we expect CFFO to stay above OIBDA less interest expense? And is there a reversal coming and what should we expect for the second half of the year?

Marc Lefar - ***Vonage Holdings Corp. - CEO***

Kevin, we expect continuing solid EBITDA performance. We expect as we continue to reduce the cost of the interest expense through the debt obligations that we will continue to be able to be in very good shape there on the interest expense.

So as we look forward, we would expect the solid financial performance from OIBDA, continuing progress on interest expense and as we discussed, we will continue to look at opportunities to recapitalize the balance sheet to the extent that they are available to us. I think the progress the Company has made financially enables us to refinance the debt at certainly lower interest rates today than we are currently paying based on a very different capital market situation now versus 2008 and also the continuing strength of the Company's financial performance.

Leslie Arena - ***Vonage Holdings Corp. - VP, IR***

Next question, operator?

Operator

Mike Latimore, Northland Capital.

Mike Latimore - ***Northland Capital - Analyst***

Just on the churn, improved again. Is the current churn level sustainable or is there more potential improvement there?

Marc Lefar - ***Vonage Holdings Corp. - CEO***

As we look at the changing mix of our customer base and the increasing penetration of the world product which churns at lower levels, we do think there's some opportunity over the long term to get some additional improvement. You never know what can happen as long as customer service quality and network quality remain improving to constant.

We think we're in pretty good shape. We don't see any real bubbles on the horizon that give us any significant cause for concern.

But I don't think you're going to see the kind of year-over-year improvement that we have seen this past year. But we are optimistic that we can get the number lower as we go into 2011.

I would caution you though that there's a little bit of seasonality in the quarter versus the second quarter with relocations of people. So think about that as a long-term trend. We expect certainly the year-over-year comparisons to be exceptionally favorable.

Mike Latimore - ***Northland Capital - Analyst***

How about for Vonage World offering? What percent of the gross subscribers that are you seeing are coming in on Vonage World and then that what percent of the base is on Vonage World now?

Marc Lefar - ***Vonage Holdings Corp. - CEO***

In total it's roughly around 80% that are coming in on Vonage World. We have now roughly one-third of our customer base on the Vonage World plan.

Mike Latimore - ***Northland Capital - Analyst***

In terms of just the gross subscriber adds in the quarter, were they sort of as you were expecting in terms of internal plan?

Marc Lefar - ***Vonage Holdings Corp. - CEO***

It was close. We actually were uncertain what we would expect to see in the four-week time of the low-end rate plan. We had not been at that price plan before with a capped number of minutes. We got a lot of learning experience there.

The quality of customers coming in was much higher. Folks have a huge willingness to actually shop online which is really encouraging for us as we think about our distribution strategy going forward.

We need to see what their acceptance is, what their usage levels are over the next few months and what their long-term churn profiles are. But we were not far off of what our expectations were.

We had said last quarter we expected to improve our net and we did. Year over year was significantly better. But as always, until we are well into the black, we're not satisfied with the progress.

Mike Latimore - ***Northland Capital - Analyst***

And then on your new mobile app for Facebook announced today, can you talk just a little bit or give more clarity around how you will -- how you will monetize that? Because it's obviously a free app right now.

Marc Lefar - ***Vonage Holdings Corp. - CEO***

Sure, as I said before, this is really just a start. Our philosophy is different than many other players in our space. We view the world as one where you don't need numbers.

Any user identity that connects any digital community should be able to be exposed and to deliver any communication features, not just voice. As we have talked in the past, we think there is significant opportunity in the messaging business where the mobile model is largely one of charging for SMS and then again for data traffic as separate packages.

We think the ability to unleash multiple communities over time as well as being able to create ad hoc communities and bring in organic contact books as well gives us an opportunity to provide a much lower cost service with greater feature functionality and value including message length and attachments that don't have limitations of instant messaging that require presence. So we think the large SMS marketplace globally is a place that there's opportunity for significant revenues.

Two other places, we think there's a lot of opportunity in some premium services. Once you start to create community and service like this, everything from visual voicemail to other enhanced services on customization, personalization, how people connect with one another can create some unusual models as people start to try to entertain and engage their friends as they're making phone calls or other contacts.

And lastly while people no longer need to have phone numbers, we certainly expect that off-net calling to mobile termination numbers and to PSTN is going to happen at the global level for an extended period of time. There is a long tail there. And certainly for international, we expect significant revenue opportunities to do off-net calling. So that's a few of them, and we would also expect as the communities expand that not everything would be a free service.

Operator

(Operator Instructions)

Leslie Arena - ***Vonage Holdings Corp. - VP, IR***

If there are no further questions, operator, we will conclude the call. Thank you for joining us today.

Operator

Ladies and gentlemen, thank you for your participation in today's conference. This concludes the program. You may now disconnect. Have a wonderful day.